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EFFECTS OF SHORT-TERM TRADING ON LONG-TERM INVESTMENTS

HEARING

BEFORE THE

COMMITTEE ON FINANCE UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

S. 1654 and S. 2160

MARCH 21, 1990

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EFFECTS OF SHORT-TERM TRADING ON LONG-TERM INVESTMENTS

WEDNESDAY, MARCH 21, 1990

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2:00 p.m., in Room SD-215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Also present: Senators Pryor, Riegle, Packwood, Dole, Roth, Danforth, and Heinz.

[The press release announcing the hearing follows:]

[Press Release No. H-16, Mar. 6, 1990]

BENTSEN ANNOUNCES HEARING ON SHORT-TERM TRADING PROPOSALS; COMMITTEE TO EXAMINE EFFECTS ON INVESTMENT, COMPETITIVENESS

WASHINGTON, DC—Senator Lloyd Bentsen (D., Texas), Chairman, announced Tuesday that the Finance Committee will hold a hearing on various proposals, including a Kassebaum-Dole bill exploring the effects of short-term trading on long-term investments.

The hearing will be on Wednesday, March 21, 1990 at 10 a.m. in Room SD-215 of the Dirksen Senate Office Building.

"Turnover in the stock markets has grown precipitously in past years. In 1970, 19 percent of the shares listed on the New York Stock Exchange changed hands. In 1988, annual turnover was up to 55 percent. At the same time, U.S. businesses have lost considerable ground competing in the world marketplaces," Bentsen said.

"Is there a connection? Many corporate managers and some economists say yes, that short-term trading puts pressure on businesses to improperly shorten time horizons when making investment decisions. This hearing will explore this issue, and will consider various possible measures to increase the tax cost of short-term trading. The hearing also will examine the connection between the increasing presence of institutional investors in the marketplace and short-term trading, and, in this context, the Kassebaum-Dole bill," Bentsen said.

The Kassebaum-Dole bill, S. 1654, would impose a special income tax on the short-term gains realized by pension funds having over $1 million in assets.

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS, CHAIRMAN, SENATE FINANCE COMMITTEE

The CHAIRMAN. This hearing will come to order. If you will, please take your seats and cease conversation.

Heads of large corporations have been telling me that there is a real deterrent these days to making long-term investments. With the threat of LBOs, a company's focus shifts to short-term earnings. Institutional investors react to short-term fluctuations by churning their stock holdings. Institutional investors may dump a company's stock if they feel that they are not going to receive a return on equity as early as they might want.

There has been a dramatic increase in the turnover of stocks on the New York Stock Exchange since 1970. In 1970, the turnover rate was 19 percent; now it is over 50 percent. With deregulation in the brokerage business, commission costs have narrowed substantially. For large institutions, commissions today can be as low as 3 or 4 cents per share. Add to that the fact that a number of institutional investors are tax-exempt. So, there is really no material cost to repeated trading. There is little to dissuade them from engaging in short-term trading and doing so in very substantial numbers.

I am concerned that too many investors today, particularly institutional investors, look just to the quarterly returns, instead of the long-term prospects, of the companies. I think that causes some concern to all of us. We need to try to strike a balance between long-term and short-term investment.

I would like for this hearing to address the following questions: Has there been a marked trend toward short-term trading behavior? If so, what are the effects of that trend on the business decisions of our country's corporate leaders?

I think we have an excellent line-up of witnesses to address these issues. I am delighted to have, as our first witness, Senator Kassebaum, who, along with the Minority Leader, Senator Dole, has taken quite an interest in this subject and introduced important legislation on this matter.

We will hear from Secretary Brady. We are most appreciative of his willingness to share his views with us today.

Then we will have a couple of prominent businessmen, Mr. Warren Buffett and Mr. Andrew Sigler, to give their perspectives.

We will also hear from two prominent economists, Larry Summers of Harvard and Myron Scholes of Stanford.

And finally, we will hear from representatives of associations with expertise in pension fund management.

I would like to defer now to my colleague Senator Packwood for any comments he has.

Senator **PACKWOOD**. No statement, Mr. Chairman.

The **CHAIRMAN**. And to the Minority Leader for any statement he would like to make.

Senator **DOLE**. I think I might wait until my colleague makes her statement, and take just about a minute after that.

The **CHAIRMAN**. All right.

Senator Kassebaum, we are very pleased to have you. You have shown leadership on this issue, and we are interested in having your views.

STATEMENT OF HON. NANCY LANDON KASSEBAUM, A U.S. SENATOR FROM KANSAS

Senator Kassebaum. Thank you, Mr.Chairman.

I would like to ask that my full statement be made a part of the record. I would just like to offer a few comments.

The **CHAIRMAN**. That will be done.

Senator **KASSEBAUM**. I think that you put very succinctly, Mr. Chairman, the issue before us, and one reason is that I think all of us share a concern and great interest in some means of addressing a mentality that has moved more and more towards a short-term outlook rather than a long-term investment strategy.

I am pleased that you are holding this hearing today, trying to find some way to provide an incentive for institutional investors to make long-term investments.

Senator Dole and I have introduced legislation which would indeed provide that incentive. Briefly, it is a 10 percent excise tax turnovers of 30-days or less and a 5 percent excise fee on turnover of 6 months or less. And let me say that that is on net gains, not gross gains. I think that has been misunderstood on occasion.

I would also say this is not designed to raise revenue. There are those who I feel believe this may be the camel's nose under the tent, Mr. Chairman, I would be happy if it didn't raise any revenue at all. But it is a strategy that I think helps encourage a change in attitude. I believe that is what is important.

If we are really serious about long-term investment, we should provide incentives not only for the individual investors, as has been considered by the sliding tax on the capital gains reduction, but for institutional investors as well.

I just feel so strongly, Mr. Chairman, that short-term behavior not only hurts our capital markets but hurts, I think, our industrial productivity as well. This has come out over and over again in statements before congressional committees. I am going to be supportive of any revenue neutral initiative that fosters long term investment.

I would commend to the committee's attention, legislation that has been introduced by Senators Sanford, Sasser,and Ford, that I am sure you are familiar with, which would extend the short-short rule on mutual funds to pension funds. That may have some merit. Again I am certainly going to support whatever I believe will encourage a change in our current short term attitude.

Thank you, Mr. Chairman.

The CHAIRMAN. Let me just ask you one question, Senator. Do I understand that this is extended to pension funds, that you single them out in your bill? Is that correct? And if short-term trading is a problem, why not to all traders?

Senator KASSEBAUM. Well, on the pension funds, the reason is that it is about $2 trillion worth of funds that are managed, managed funds in the market, and if there would be a tax on all transactions? Is that what you are saying?

The CHAIRMAN. Yes.

Senator KASSEBAUM. I think it is because, in my mind, you have debated this in the Finance Committee before, and a tax on all transactions, and it has never gone very far.

It seemed to me this was not designed as a tax—that was not the purpose—on all transactions, but as an incentive for a change in behavior; and because of the pension funds moving such large amounts of money, that this was, as I say, an incentive, not designed to be a tax as such.

The CHAIRMAN. Well, I know the next witness, Secretary Brady, has another engagement. So I will cut my questions.

Senator PACKWOOD. No questions, Mr. Chairman.

The CHAIRMAN. Senator Dole?

OPENING STATEMENT OF HON. BOB DOLE, A U.S. SENATOR FROM KANSAS

Senator DOLE. Mr. Chairman, if I might include my statement in the record in support of the bill? Senator Kassebaum was the primary sponsor, and I am very pleased to be a cosponsor.

I think, for the reasons stated by the Chairman and the reasons stated by Senator Kassebaum, it is important to start the dialogue or start the debate.

Maybe there are other ways of advertising the problem. Maybe you can change ERISA. We are not looking for revenue; we are looking at how to change behavior, and how to protect the pension funds, and how to do all of these things?

Because, as the Chairman pointed out, the turnover rates are greater and greater, and people operate from quarter to quarter, trying to make things look better than they may be. We believe that this all may lead to some legislation or some change in behavior that will be beneficial. I think that may be the conclusion, at least as I understand it, reached by the Secretary of the Treasury. He doesn't endorse this bill, but he indicates that it may open the door for negotiations with the committee and the business community aimed at finding the right way to proceed.

So I thank the Chairman and Senator Packwood for holding these hearings, and I would ask that my statement be made a part of the record.

The CHAIRMAN. Without objection, that will be done.

[The prepared statement of Senator Dole appears in the appendix.]

Senator KASSEBAUM. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you for your contribution.

Mr. Secretary, we are pleased to have you. We know the many demands on your time and your schedule. My understanding is that we have agreed to turn you loose by 2:45. Unless my colleagues have a statement, we will defer to you, Mr. Secretary.

[The prepared statement of Senator Kassebaum appears in the appendix.]

STATEMENT OF HON. NICHOLAS F. BRADY, SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary BRADY. Thank you, Mr. Chairman.

I appreciate the opportunity to meet with you today to discuss the effects of short-term investment behavior on the ability of American companies to compete in world markets. This is a subject I have spoken about a great deal.

In order to achieve the Administration's goal of enhancing economic growth by improving our nation's ability to compete in an integrated world economy, we must adopt longer horizons in both the corporate and investment community.

Short-term investing is neither all good nor all bad. Some trading activities are necessary to provide liquidity and efficiency to the marketplace. The existence of a highly liquid market which efficiently reflects underlying economic values is important to providing low-cost capital to American businesses, and the cost of capital influences the investment horizons of corporate managers.

For projects which have long-term payoffs, the cumulative effect of a high funding cost or cost of capital can be devastating. Thus, as we review policies with an eye towards competitiveness, we must not lose sight of the importance of capital costs on investment horizons.

The Bush Administration is committed to lowering America's cost of capital. With this in mind, the President transmitted to Congress the Savings and Economic Growth Act which, as you know, has been introduced by Senators Packwood, Dole, and Roth as S. 2071. The Family Savings Plan is designed to expand the pool of personal savings, which directly influences the supply of capital available for America's corporations.

The SEGA legislation also reinstates a preferential tax rate for capital gains realized on investments by long-term investors. Our capital gains proposal is designed specifically to encourage all investors to adopt a longer term approach toward stock ownership, which is the subject of this hearing today.

We do not believe these measures alone will resolve the higher level of capital costs faced by American businesses as compared with some foreign competitors. Studies on this subject conclude the gap is considerable. None of our major trading partners fully taxes corporate income at both the corporate and personal levels.

The Treasury Department is engaged in an extensive study of ways in which the personal and corporate tax systems could be integrated to prevent the double taxation of dividends. This too is an important element in lowering the cost of capital, which is so important to the economics of long-term investing.

Long-term investing is more than just pure economics. A second critical element in the competitiveness equation is the relationship which exists between the providers of capital, the investors, and the users of capital, the corporate executives and corporate managers.

Short-term stockholders are usually unwilling to stay the course and participate as owners. One short-term investor replacing another short-term investor is not likely to provide effective accountability or encourage long-term management decisions. At the same time, corporate executives who are worried about their shareholders' commitment to the company's long-term strategies are more likely to focus on producing short-term results in an attempt to bolster their firm's stock price.

We need to examine the current relationship between corporations and investors. If executives felt their shareholders were committed to maximizing the long-run value of the company, perhaps they would be bolder in pursuing aggressive strategies with the more strategic payoffs which are required to compete in world markets. Over time, these strategies could create greater shareholder wealth; but, to the extent that investors feel that the system is unresponsive and insensitive to their interests, they may be unwilling to make a long-term commitment.

I think we need to create an environment with more investors who can understand a company's long-term strategies and who would back the company as it strives to prove the merits of those strategies. Together, investors and executives need to operate within a system of corporate governance that can effect management change consistent with long-term goals.

Our country's pension funds, which contain retirement savings for 75 million Americans, are the ideal candidates to provide the committed capital our corporations need. They also have the broad knowledge to understand the development of long-term corporate strategies. This doesn't mean that outside shareholders should run the daily affairs of companies; but, as shareholders, they are an essential element in a system of governance that provides them a voice in setting goals which would lead to policies to enhance the long-term value of their investment.

I believe we should encourage executives and shareholders, together with the State and Federal Governments, to review the present corporate governance process in order to provide an environment more conducive to dialogue and partnership.

If we can create an atmosphere which harmonizes the interests of managers and shareholders, I believe it will lead to a more responsible and less destructive way of converting shareholder/owner views into long-term plans. Then, less attention will be paid to policies aimed at short-term profits by corporate managers whose primary goal is avoiding a takeover.

Now let me turn to S. 1654. As I have indicated, I believe that steps are needed to lengthen the time horizons of investors and corporate executives. However, I am concerned that we have not thought long enough to be sure S. 1654 is the answer.

S. 1654 takes the approach that a tax should be placed on gains which are realized by pension funds on the sale of stocks held less than 6 months. Perhaps we should apply the ERISA rules to make clear that the fiduciary duty to maximize return for fund beneficiaries is best achieved by long-term investing, not by short-term trading. Last Spring, the Treasury and Labor Departments took a step in this direction by pointing out that fiduciaries do not have to accept any tender offer if they believe the long-run value of the stock is higher.

Although the economic impact of speculation and arbitrage is not fully understood, it is clear that an excessive amount of these activities has never produced lasting values. Yet, today in the U.S. there is a substantial amount of capital, not just money but some of the brightest minds in the country, committed to playing short-term trading games. Efforts to reduce excessive speculation in our markets would permit more of our human and economic resources to be committed to allocating capital to the companies which provide jobs, produce products, and preserve our nation's standard of living.

Defenders of all the turnover in our markets cite liquidity as the benefit of this practice. Liquidity is not the ultimate purpose of the market; an effective and efficient allocation of resources is.

I served as chairman of the Presidential Task Force on Market Mechanisms established to explore the causes of the October 1987 market break.

One of the conclusions the Task Force reached is that reducing speculative trading would raise investor confidence in the markets. Others would point out that, by most measures, overall volatility in the U.S. equity markets has not increased substantially over the past 15 to 20 years, even though trading activities have grown manyfold. This may be true, but there have been a few days which really shook the market and threatened the stability of the payments and settlement system, most notably in October of 1987 and 1989.

The task Force report suggests that excessive speculation increased the speed and violence of these declines. These sudden, precipitous drops have shaken the confidence in our markets, which is just as important as what has happened to turnover rates or measured volatility.

I believe attempts to encourage longer investment horizons do send positive signals to investors. This hearing itself is important, as it raises the critical issue of pension fund goals and objectives. While the Treasury Department does not now support S. 1654, we applaud its objectives of promoting long-term investment.

We would be interested in working with the Committee to come up with a considered approach which would balance the goals of liquidity, providing committed capital, and providing a secure source of retirement income. We do have the worry that agreeing to a tax on pension funds might lead to taxes on individuals and other entities, to which we would be opposed.

We are only suggesting that pension and other tax-exempt funds be placed in a special category in this country. They have been granted freedom from taxation; why shouldn't they be this country's reservoir of long-term capital? Pension funds have long-term obligations; short-term speculation should have no place under this view. But taxation should be viewed as a last resort in establishing this goal.

Enforcement of S. 1654 could prove difficult. This legislation leaves many questions unanswered, such as how to prevent the investors targeted by this tax from achieving the same economic effect by using the options market and other mechanisms without technically triggering the tax.

This bill provides an exemption for hedging transactions. While the use of futures in hedging activities is certainly a legitimate business activity, the bill provides little definition of what kinds of activity are intended to be excepted by the hedging exception. Resolving these definitional issues could be difficult.

As I said before, not all short-term trading is bad. There is a legitimate need for market makers who buy and sell securities and attempt to secure a narrow spread. These investors reduce the overall cost of transactions and provide liquidity, which are characteristics needed for efficient markets. However, in my opinion, it is questionable whether our nation's pension funds ought to be the ones to fulfill this particular role in the markets.

In conclusion, I concur with the goal of the sponsors of this legislation. I believe longer investment horizons are critical to our nation's future world position. However, I again recommend to you the Savings and Economic Growth Act of 1990, S. 2071. My strong conclusion is that, if we take action to affect the role of pension funds, it should be done within the framework of the SEGA legislation. After all, it is the same subject.

Mr. Chairman, thank you very much.

The CHAIRMAN. Thank you, Mr. Secretary.

Because of your other appointments, I am going to limit questioning by the members to four minutes, to try to get you out of here at 2:45. I will start with my own.

I note at the end of your statement you said you are not sure that it should be the obligation of the nation's pension funds to fill this particular role in the market. Well, if not the pension funds, then who?

Secretary **Brady**. Well, I don't think, because pension funds reduce the amount of their short-term trading, that our liquidity is going to be narrowed to a point where it is going to severely affect the market. And as they turn over their long-term investments, that produces a certain amount of liquidity itself. In terms of the public, they add measurably to the amount of liquidity we have.

I think this is kind of, in a certain sense, an academic subject, Mr. Chairman. This might produce a dip in liquidity for a short period of time, but nothing that I worry about.

The **Chairman**. I got the feeling, though, that for some reason you would not have pension funds accept this obligation, if I read your statement correctly. I don't know where you are headed. If they are not to undertake this obligation, who else would you have do it?

Secretary **Brady**. To take the obligation of providing liquidity?

The **Chairman**. No, no. To take the obligation to pay the additional tax. Perhaps I am singling out one of your statements without enough of a preface. Were you referring just to liquidity at the end?

Secretary **Brady**. Yes, I was.

The Chairman. I see. Well, I misunderstood.

Then let me ask you another question that confounds me a bit. I am advised that Japan's turnover rates are even higher than those in the United States. The rate in Japan was 98 percent in 1988, compared to 55 percent in the United States, despite the fact that Japan has a securities transaction tax. Yet, I am often told how the Japanese take such long-term outlooks when they are making their investments.

What about West Germany, another powerful competitor, which has even higher turnover rates. How do you reconcile these examples with the goal of trying to do to reduce the level of short-term trading in this country?

Secretary **Brady**. I think it is a good question. But I would suggest, if we are going to make that kind of a comparison, we ought to make it wider than just looking at the existence of a transaction tax on turnover.

In Japan the cross-ownership between corporations is extensive.

The **Chairman**. And there is a great deal of involvement by the banks in Japan.

Secretary **Brady**. That is correct, the banks as well. So I don't think you can compare Japan with the United States. They do a lot of things differently than we do, and I don't think we can look at turnover and at the existence of a transaction tax as proving anything.

You would have to look at it within the whole framework of the fact that their system is designed to give corporations a long-term view and does so by a combination, as you have said, of ownership by banks, ownership of one corporation by another, and the policies of the ministries which have an enormous effect.

In the case of Germany, the commercial banks have an enormous influence on corporations. You can't get a takeover done in Germany without the permission of the lead banks, period.

The CHAIRMAN. I remember that from my days in the private sector, where I was involved in these activities. I quite agree.

Senator Packwood?

Senator PACKWOOD. I don't think I have any questions, Mr. Chairman.

The CHAIRMAN. Senator Dole?

Senator DOLE. I have no question, except to indicate, as you indicated, that maybe we can sit down and come up with some answer, maybe not a perfect answer—as to how we might have an impact on behavior. If the Treasury Department is willing to do that, I am certain that Senator Kassebaum would be very willing to do so.

The CHAIRMAN. Senator Heinz?

Senator HEINZ. Mr. Chairman, thank you.

Nick, I read your statement, and I think you have probably come to the right conclusions; but I must say I am a little disappointed in some of the opportunities that you could have taken advantage of, both in terms of submissions by the Administration and in terms of what you said today.

You talked a lot about the need for a long-term investment horizon, and yet the Administration's Savings and Economic Growth Act omits the indexation of capital gains which, of all the things you could do with respect to capital gains, would give people an incentive to invest for the long term. Instead, the Administration's capital gains bill is aimed just at the short term. If there is time, I hope you might explain why you didn't press the option of indexation, where people clearly have an incentive to invest for the long term.

Second, you did mention corporate governance; but we had a hearing in the Banking Committee about how large pension fund managers do their fund management. They basically said, "We don't have any time to look at the basics. We don't pay any attention. We really just manage our money for the maximum short-term gain we can get. We don't pay any attention to whether a corporation is particularly well managed or not; we don't even pay any attention to whether the board is an inside board or an outside board," in spite of the fact that some public pension funds, such as New York, under Ned Regan, do.

Finally, in terms of the volatility issue, you did a lot of work on that issue as chairman of your commission, and it seemed to me that one of the things you identified was that there was a good deal of intra day volatility, and that you may have come to the conclusion that some of the rules that apply to index arbitrage that permit selling short on a down-tick might have been responsible for some of that.

It seems to me that commentary on that particular problem was omitted here as well. I am puzzled by those omissions or differences, and I would welcome any comment you have got.

Secretary BRADY. Well, you have raised three subjects: one is the indexing of capital gains. If I could just quarrel with one characterization that you made, Senator Heinz, you said our capital gains plan was aimed at the short term. Actually, once it phases in, it gives the break to people only who hold for 3 years—not only that, but in a graduated way, the people who hold for the longest time get the biggest break.

But to answer the more fundamental part of your question: (1) we did look at it, and we think there is a lot of merit to indexing. Unfortunately, it is expensive in terms of how we can pay for it. And (2) the IRS always raises a question with us as to its being complicated. So those are the reasons we did not include it in the SEGA legislation.

With regard to volatility, I just didn't want to burden this testimony with a lot of things that have been said before about volatility: the difference in margins between Chicago and New York; the existence of the cross traffic between the futures markets and the stock markets which wash back and forth by the tap of a computer; the short-selling rules, the fact that you can short sell the whole market by selling futures in Chicago, and we have a short-selling prohibition on a down tick in the New York market, which is born out of the old speculators' trying to rush the market, Bet-A-Million Gates and Jim Fisk and all of those.

Senator HEINZ. If I might interrupt you, isn't that a central element at which we ought to be directing our attention?

Secretary BRADY. I think so.

Senator HEINZ. If we are worried about volatility and all of the issues that I know Senator Dole and Senator Kassebaum are properly worried about?

Secretary BRADY. Sure.

Senator HEINZ. All right.

The CHAIRMAN. Thank you.

Senator Riegle?

Senator RIEGLE. Mr. Secretary, do you have a sense for the percentage of pension funds that are doing a lot of what looks like churning who actually out-perform say the Dow Jones average?

Secretary BRADY. Senator Riegle, I have seen all sorts of studies, so that I stopped looking at them, about who does what. You can get studies, and I think there are some produced by the Labor Department that show that those who have pursued short-term strategies don't do as well as long-term investors. I am sure you will hear testimony today from others who will disagree with that. I think this issue is as long as it is wide.

I do admit to a predisposition here that happens to fit with what I think are our national goals, which is that long-term vesting is a sounder way to do it; it also suits what we want out of our corporations.

Senator RIEGLE. Well, I have seen data, that I think is reliable, that indicates that a very large number of pension funds want to do a lot of the trading, a lot of the trading volume, and end up not doing as well as the Dow Jones averages. So you see the anomaly of a lot of trading activity and not doing as well as something as the Dow Jones average would do.

Secretary BRADY. It wouldn't surprise me.

Senator RIEGLE. When you say you think of a tax as a last resort in trying to control pension short-term trading activity, and you gave your reasons why, what other options are open to us to try to influence behavior?

Secretary BRADY. I must admit, during the time between Senator Bentsen's invitation to appear before your committee and today, I haven't had a chance to go over it again; but when I first became Secretary of the Treasury, in 1988, we had some time during that Fall to look at it, and we looked at it with the Labor Department.

There are some things that, if you really wanted to make changes in the ERISA regulations, would make a difference, and we tried to make some that could be agreed to quickly at that time, such as saying to pension fund managers that they did not have to take a tender offer price at a substantial premium to the market if they thought the long-term values represented by the corporation were greater. Frankly, I would have thought that that would have made more of a dent in the process than it has. I am very disappointed, frankly, that that didn't have more of an effect in trying to get people to focus long term.

So I do not have any other options now; but we are going to start again our discussions with the Labor Department, to see whether we can produce some more changes in the ERISA regulations, which would be aimed at trying to give people the conviction, courage, and legal authority to turn down an offer that is 25 or 40 percent above the market, if they like an American company that is producing good products, producing quality products, and employs people in a way that is important to this country.

So, I think those things are not inconsistent with providing good pension fund results.

Senator RIEGLE. But is that another way of saying that by one means or another, in your own mind—and you have got a long professional history in this area—that you feel some sensible means has to be found, to create a longer-term investment attitude and philosophy and practice here? Is it important enough that we've got to find some way to carry it out? Or is it just something that would be good to have happen, but if it doesn't happen, well, we can just shrug our shoulders about it?

Secretary BRADY. I think we have to find, to use your words, some way to get it carried out.

Senator RIEGLE. And in terms of any other ideas that you may be considering or that we ought to take a look at, is there anything beyond those ERISA adjustments that you have just described, in short of a tax, a direct tax, that is worth putting on the table, just to at least think about, as you see it?

Secretary BRADY. I can't think of any other precise prescriptions to give you, Senator Riegle, at this point in time. I do feel that, and it is not just putting feathers in the air, that when I say this hearing is important, I mean it is important. And I think the discussion and weight and horsepower that Chairman Bentsen has brought to bear on this subject are going to make a dent in people's minds, "This is something we ought to get done."

Senator RIEGLE. Thank you.

The CHAIRMAN. Senator Roth?

Senator ROTH. Thank you, Mr. Chairman.

Mr. Brady, would you be willing to accept some taxation of short-term trading in exchange for a program such as the Family Saving Plan or capital gains?

Secretary **Brady**. Well, Senator Roth, I am not in favor of taxes, as my boss has said any number of times. [Laughter.]

I like what I am doing here at the Treasury, and if you will excuse—[Laughter.]

If you will excuse me, I have not answered that question directly. I do feel that refocusing the goals of our pension system, and others as possible, is important, and I also think that the Family Savings Plan is important.

Senator **Roth**. I would certainly agree on that latter point. I hope we make some progress on that.

Is a transaction tax to reduce short-term trading comparable to an increase in the capital gains tax?

Secretary **Brady**. No, I don't think so.

I hope you understand, Senator Roth, I am not suggesting a transaction tax. I know this is an argument with a little sophistry in it; but if there was a short-term trading tax—and I am not suggesting that there should be—nobody has to pay that tax unless they short term trade.

As I say, I know there is some sophistry in that argument, because you could use it with respect to tobacco and alcohol, as well.

Senator **Roth**. Is there conclusive evidence that this higher stock turnover is bad for the economy?

Secretary **Brady**. Well, I don't know about the higher turnover. No, I don't think, necessarily. I think that the method by which it is carried out—if you are talking about the relationship between the Chicago futures market and the New York stock market and other markets—has imperfections which, if they are ironed out, will make a big difference and go some measured way towards making sure we don't have down-drafts like we had in 1987 and in the Fall of 1989. But I don't feel that turnover, per se, is bad.

Senator **Roth**. That is all the questions I have, Mr. Chairman.

The **Chairman**. Mr. Secretary, I just finished reading "Barbarians At the Gate" and "Liar's Poker," I must say, it buttressed my feelings for long-term investment in this country.

I strongly agree with what Treasury has done in notifying trustees, people in fiduciary positions, that they don't have to take a short-term gain if they believe that holding long term will be better for the stockholders. I agree with that.

But, let's get back to the question of whether you make more for your stockholders, by investing short term or long term. Look at Warren Buffett. I am not sure that his success comes from just long-term investing, which he supports. The astuteness of the fellow that is doing the investing is also important.

You stated here "to maximize return for fund beneficiaries is best achieved by long-term investing, not short-term trading." I am not sure how you do that with legislation and make that point to a trustee.

Secretary **Brady**. Again, I shouldn't give you an off-the-cuff opinion on ERISA; but I think, because of the complicated nature of those laws, at least as I observed as a member of finance committees of corporations who had under their jurisdiction the investment of pension funds, a tremendous predisposition on the part of pension fund trustees and corporate directors to take the highest price at the time. I think that is a sorry commentary on our system, and I think it is counterproductive, because it gives no real weight to the force and horsepower of long-term committed goals.

So I think we could do something in the ERISA law area that would be meaningful, if we were willing to take a chance about the importance of investing in the long term. By "chance," I mean give people more latitude in deciding what that means.

The CHAIRMAN. How does a short term capital gains tax, as proposed under Senator Dole's piece of legislation, compare to a stock transaction tax?

Mutual fund management companies are trying to keep their transaction costs down to less than 1 percent a year if they can; they tend to get criticized if they increase that cost. A transaction tax, if investors really roll and churn their stocks, would add up very quickly and run above 1 percent. However, a short term capital gains tax, might not show up under the operating costs but would be passed on to the shareholder.

Secretary BRADY. When you say capital gains, are you referring to the Dole-Kassebaum legislation?

The CHAIRMAN. Yes.

Secretary BRADY. The 10-percent tax?

The CHAIRMAN. If we were looking at a mutual fund management company, how would the Dole-Kassebaum proposal compare to a transaction tax of so much a share.

Secretary BRADY. Well, as I understand it, you don't have to pay the Dole-Kassebaum tax if you invest past 6 months or a year. But with a transaction tax, you pay it if you hold the stock for 10 minutes or 2 years. So I see a big difference between those two.

The CHAIRMAN. On the other hand, the transaction tax, if one was churning stock and paying the tax several times a year, the cost of operations would become exorbitant.

Secretary BRADY. I can see what you are saying, Senator. I just feel that a transaction tax is a cost-of-capital increase and the kind of thing that Senators Dole and Kassebaum are suggesting is not, because you have the alternative to invest in the long term.

I must admit that you are singling out one part of the market, the pension funds, in one case, and the whole panorama, in the other.

The CHAIRMAN. Once again, I promised to let the Secretary get on his way, in 2 minutes. Does someone want to ask a 2-minute question?

Senator HEINZ. I've got a 1-minute question.

The CHAIRMAN. With a 10-minute answer?

Secretary BRADY. That is, a 10-minute question with a 1-minute answer? [Laughter.]

Senator HEINZ. That is what you got the first time.

Secretary BRADY. I know it is going to cost me, Senator. I know. [Laughter.]

Senator HEINZ. He is a very smart witness, Mr. Chairman.

Which churns more or which has a higher turnover, mutual funds or pension funds?

Secretary BRADY. Senator, can I provide that later? I don't know.

Senator HEINZ. I think you will find that the answer is mutual funds consistently have had a higher turnover, a mean turnover ratio, than pension funds, in spite of the fact that mutual funds are taxed.

Second, in your judgment, were we to enact the Dole-Kassebaum legislation with the 10 percent for 30 days, 5 percent for the next 180 days as a capital gains tax, as a former person who had been in the investment management business and knowing these fellows are all subject to the prudential rule of management, would it make any difference? Would people trade any differently?

Secretary BRADY. I think so.

Senator HEINZ. You do?

Secretary BRADY. I do.

Senator HEINZ. Okay. Thank you.

The CHAIRMAN. Thank you very much.

Secretary BRADY. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you for coming, Mr. Secretary.

[The prepared statement of Secretary Brady appears in the appendix.]

The CHAIRMAN. Our next witnesses are Mr. Warren Buffett, chairman of the board and chief executive officer of the Berkshire Hathaway Co., from Omaha, NE; and Mr. Andrew Sigler, the chairman and chief executive officer of Champion International Corp., Stamford, CT.

Gentlemen, we are very pleased to have you.

Mr. Buffett, we are appreciative of your changing your schedule to come down here to join us, and we will let you lead off.

STATEMENT OF WARREN E. BUFFETT, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, BERKSHIRE HATHAWAY, INC., OMAHA, NE

Mr. BUFFETT. Mr. Chairman, it is a pleasure to be here.

I want to say that I agree completely with the concerns that you expressed in your opening remarks, and I agree with the concerns that Senators Dole and Kassebaum are addressing with their bill.

However, I would have to say I disagree with their estimate and Secretary Brady's estimate expressed just before he left, as to the degree the tax numbers they set forth in their bill would affect behavior. I believe a 10-percent tax, an excise tax, in effect, on transactions of under 30 days and 5 percent from 30 days to 180 days, even if the hedging rules were very tight so that there was no escape through that possible loophole, I think that those rates would have a very small effect on the behavior of investment managers.

But I do believe that behavior modification is possible—and more than "possible," I think it is certain—through the Tax Code at some rate level. I noticed that when Senator Riegle raised the question of whether there were other ways of getting at behavior modification, the Secretary was somewhat hard-put to come up with an answer on that; but he also agreed on the necessity of modification.

You can get any message through to investment managers that you wish to get through. You can instruct them so they don't have trades of under 10 minutes or you can instruct them so they don't have trades of under 10 years, depending on how the tax law is structured.

I would say that it is important that some investment managers—not all, by a long shot, but they wouldn't be incurring the tax, anyway—do modify their behavior.

I might say that you are not only on the side of the angels in this respect but, in my view, you are on the side of the investors, because it is a truism that, with two exceptions—which, if the committee wants me to get into I will, but I will skip for the moment—with two exceptions, all that investors, in aggregate are ever going to get out of the American corporate system is going to be the amount of the profits that the companies that they invest in earn less what I would call the frictional costs of their investments.

Now, the aggregate profits will run perhaps on the order of $200 billion annually. The annual frictional cost—that is, commissions, investment management fees, commissions on derivative instruments, the works—probably run in the area of $20 billion.

So, American investor as a whole, of which pension funds are an important part, are in effect paying a self-imposed 10-percent tax right now, in addition to any income taxes paid, for the privilege of changing chairs among themselves.

The question for investors is how to either increase the aggregate profits of the companies in which they invest or how to reduce their own frictional costs. Either one will improve their net return. Nothing else will. They can take in each other's washing 10 times a day, and all that will do is increase frictional costs, it will not increase the profitability of the businesses; it is good for the brokers, but it is poison for the investor.

One other point I would like to briefly address, because you have heard some about it already and are going to hear more, is the liquidity question.

Liquidity, to the true-blue Wall-Streeter, ranks somewhere on a scale between mom and apple pie. For, to him "liquidity" equates definitionally with "activity." If Jess Unruh were here with us today, he might say that "activity is the mother's milk of Wall Street," and you will find many witnesses who will tell you that all kinds of terrible things will descend on the investigating public if liquidity is endangered.

But I would say that "liquidity" has a dimension to it that goes far beyond simple measures of activity in the market, the quantity of trading. The liquidity of our markets, as measured by activity, was probably never greater than in 1987. We had introduced these marvelous derivative instruments so that volume in indexed futures alone was equalling in daily dollar volume, the activity on the New York Stock Exchange. This we managed to replicate the New York Stock Exchange with some unreal index numbers, and created enormous liquidity, as defined generally in Wall Street.

Many people who didn't want to own stocks, including many pension funds, adopted various strategies encouraged by that apparent liquidity, because they thought they could get out very easily if a given market signal appeared. In fact, many adopted a technique whereby the lower stocks went, the more they sold of them, which is something that goes a little bit against my grain, but nevertheless was sold to people. The Brady Report said that between $60-

and $90-billion worth of stocks were so poised for sale upon receipt of such a market signal.

So a day came along, October 19th, when 99 percent of the stocks at the end of the day were held by the same people who held them at the start of the day; but, with less than 1 percent of the stock universe trading and with this great liquidity which had been so trumpeted throughout Wall Street, some $500-$600 billion of market value was erased from a less-than $3-trillion market.

Liquidity depends not only on the amount of trading, it depends on the attitude of the participants. You don't need an enormous amount of activity to provide adequate liquidity if people are investing with a long-term horizon. But if they are all playing beat-the-gun or musical chairs, no amount of activity will create enough liquidity.

Thank you.

The CHAIRMAN. Thank you very much.

Mr. Sigler?

STATEMENT OF ANDREW C. SIGLER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CHAMPION INTERNATIONAL CORP., STAMFORD, CT

Mr. SIGLER. Mr. Chairman, I thank you for the opportunity of being here.

My position—hopefully brought from a perspective of someone who is trying to run a business in an industry that is inherently long term—my position is that there is pressure for short-term results out there, and it works—it impacts management decision-making.

No one is to blame. We have had a very major systemic change in the way our system is constructed, i.e., in the ownership of public corporations, over the last 20 years, and we find ourselves in a situation today "that is just the way it is." I would like to make a couple of points to that.

First of all, managements of corporations have to run the businesses in the way their owners want them to. There might be some aberrations from that, but owners set the standards and set the rules and set the performance hurdles. And if managements don't meet those standards, eventually management is replaced.

Our owners are institutions. They are most often pension funds. Champion is owned in excess of two-thirds by institutional funds and mutual funds would be a small part of that.

The pension funds are roughly two-thirds private funds, one-third public funds. They churn. They churn a lot. There are all sorts of studies to prove this, and some of the people after me will give you numbers on this. The private churn a lot more than the public; but, for the most part, the large public funds are indexed, which makes a very big difference.

The short-term pressure doesn't necessarily come only from the churning; the short-term pressure comes because money managers want short-term results. They want short-term results because that is how they are judged, that is how they are successful, that is how they maintain their ability to hold the money they do manage, that is how they maintain an ability to acquire money to manage, and that is how they make money, by taking a cut of the earnings on the money that they manage. They think of themselves as investors, not as owners.

The short-term pressures on me and everyone else in my position take a couple of forms. They are obvious: there is pressure for higher earnings this quarter and next quarter; there is constant pressure for such programs as stock repurchases; and there is pressure to do the things that we have generally put into that wonderful category of "restructuring." Over the last 10 years all of those have been brought about by pressures that say "a dollar made today is what I really want."

In my business, which is a capital-intensive business, I can give an excellent example:

Less than 2 years ago we announced a $500-million program of expanding a mill that we have in Cortland, AL. The payout for that expansion was exceptional and recognized by everybody the day we announced it. The next day after we announced it, our stock fell 10 percent, and two large funds totally liquidated their position. We are criticised for doing things like that expansion rather than doing the kinds of programs that would show, according to the institutional investors, that I cared for my shareholders by buying back my stock, et cetera. So, this is not a theoretical issue; it is a fact that you live with all the time.

Who is to blame for this? We are all to blame. How can you blame someone for taking a short-term attitude if that is the way he is required to be successful in what he does?

The irony is that the private pension funds are essentially owned by the same people who are receiving the pressure from the institutions and who are complaining about their short-term perspective. That is why I think some of the ERISA suggestions that have been brought up already are very much to the point, and I will mention that in a minute.

Institutional performance? Generally, the institutional performance has been the stock market average performance less the fees. There is really no way it can be anything else, because the institutions are the market.

Now about Senator Kassebaum's idea: I think we have to take it very seriously. There is immense business opposition. The business opposition is all from the prospective of being an investor and being concerned about starting to tax the money that we put aside for pensions, and it is major money for all of us for pension funds.

I share this concern. I think it would be a very serious problem if we started to tax pension funds generally. But I think the other problem—of short-term trading—is so big that we have to start looking at that limited alternative of taxing short-term gains.

There is one other point that I would like to make: when these pension funds were created, no one visualized what would happen to them. We have now created funds that own corporate America. The concentration of power is absolutely immense. What three or four major pension funds can do to any corporation or any groups of corporations would have been inconceivable ten years ago; now they own and direct the economic system.

If you look at where these funds are going just by the actuarial numbers, when they are going to have twice as much money in 5 years, you have to say to yourself, "Where do we go from here?"

I think the idea of stopping the churning is one positive proposal. I support trying to make long-term owners out of investors. I also thoroughly support, and have testified to this effect in other forums, taking a serious look at the ERISA laws, to try to come up with a way to make all of these investors think of themselves and act as owners. If those two things don't work, I think we have to re-look at the whole corporate ownership system, because it has dramatically changed and we have a very serious problem with it.

Thank you.

[The prepared statement of Mr. Sigler appears in the appendix.]

The CHAIRMAN. Mr. Buffett, do you think that corporate managers prefer their stock to be held by institutions or by the public? Which do you think is better for the markets?

Mr. BUFFETT. Well, in all honesty, I would have to say that most corporate managers would prefer that their stocks be held by whoever will bother them the least. They all prefer cocker spaniels to German shepherds. [Laughter.]

But I would say this: At Berkshire Hathaway we are about 98 percent owned by individuals, and 90 percent of our shares are held by people who held those shares 5 years ago. So, we have encouraged long-term owners, and I frankly think it is easier to find them among individual investors than it is among institutions.

The CHAIRMAN. Mr. Sigler, what do you think the effect of short-term trading is on investment in R&D. How does that affect your company?

Mr. SIGLER. I can respond more to the impact on long-term capital investment. R&D is a major expense of our company but not, certainly, what it would be to a pharmaceutical company.

I have to agree with Warren's comment, that one of the things we have to be careful of when we talk about "changing a system" is we might further move it away from people having to be responsible.

I think we all try to balance the short term versus the long term interests. But there is no question: if you are in a business that requires making major capital expenditures and building mills that cost hundreds of millions of dollars, then there are those times when you are starting up the mills that your profits suffer, and you take an awful beating in the market at that time. I don't think there is any question that the law of survival on managers makes them back away from doing the long-term investments because of this reaction. The pressure is there.

The CHAIRMAN. I was one of the authors of ERISA. We share jurisdiction with the Education, and Labor Committees. You propose changing ERISA to encourage long-term investment. How?

Mr. SIGLER. I'm not sure it is even necessary to change the law. I think there have been some problematic interpretations of the law—and I will go back to Secretary Brady's comment. There has been a very strong feeling among the trustees of a fund—and Champion hash a billion-dollar fund—that you should not exercise judgment on fund decisions; rather, you should pick outside managers and let them exercise judgment in order to avoid liability. This has been the recommendation of lawyers and it has taken decisions away from the very people who might look at something long term, and from the perspective of management, and put those decisions in the hands of investors.

Again, I agree with the Treasury Secretary that the actions they have taken to help change that interpretation have made modest inroads. But the fact of the matter still is that most private pension fund trustees feel that ERISA says to them, based on the words that everything "has to be done soley in the best interests of the pensioner," that they cannot get involved, they cannot talk about long term impact and that they just have to let a money manager do what he wants to do. I think that is a very serious problem.

The CHAIRMAN. Mr. Buffett, when Senator Riegle asked the question about other ways of doing it, you said the Secretary did not come up with too much of a different approach.

Several ways have been proposed, to slow down churning: a securities transaction tax, or the approach of Senator Dole and Senator Kassebaum to tax short-term gains. How do you feel about these? Are there other possible approaches that might be within the jurisdiction of this committee?

Mr. BUFFETT. Mr. Chairman, I would prefer a quite heavy tax on short-term gains, and I would probably define that holding period as 1 year or less.

A transaction tax admittedly hits the people that are trading the most, in a manner proportional to their trading, but it also acts as a drag on the investor; although admittedly it would be a small drag. But I don't really see any reason to have a special tax on a 5-year holding even if it were a small amount. Why not go after the problem directly and tax heavily the short term trades?

I would say this: If the choice were between no special tax on short-term trading and a transaction tax, though, I would go with the transaction tax.

The CHAIRMAN. I see we have a vote on. Senator Pryor, could you preside while I run to make this vote?

Senator PRYOR. Yes, and I will do it from over here, Mr. Chairman.

The CHAIRMAN. All right.

If you will excuse us, some of us have to vote. We will take turns.

Senator PRYOR. I assume we are using the early-bird rule here. Senator Packwood?

Senator PACKWOOD. Mr. Buffett, I am in your debt: you and I spoke back-to-back to Solomon Brothers some years ago, and I came early just to hear you speak. I was fascinated by your stories of Capital Cities, Mr. Murphy, and the ABC transaction. It was interesting to hear how you got into the transaction, and why you got included—because of his long-term management ability.

One of the statements that you used then, I will repeat now—I have used it over and over, giving you credit—is the definition of a business cycle. As you described it, a business cycle is "the innovators, followed by the imitators, who were followed by the swarming incompetents." [Laughter.]

I thought it was a wonderful expression of the way the business cycle seems to work. You have had an extraordinary career. You've been at the top of that pyramid, and it seems like you are moving on just as the "swarming incompetents" came along.

I want to ask Mr. Sigler a question about these long-term managers that want you to sell your timber. I obviously have an interest in that subject.

Mr. **Sigler**. We are constantly discussing the company with the financial analysts, analysts from either the institutional funds or the street side but principally the large funds.

It is recommended to us quite often that, because of the various pressures that have created the rather high price of wood in your part of the world, this would be a wonderful time for us to spin off our timberlands. We have 6 million acres of trees, and we could make X or Y.

We even have some representatives of various firms that have suggested specific deals and they would help us,for a fee, to do that. When I raise the question, "Unfortunately, we need those trees to make paper out of, and what would we do in the long term for fiber supply?" people think I am kidding.

That is a fascinating issue, but it is a question that comes up constantly.

Senator **Packwood**. Now let me ask you a question: Let us say you sold your timberland. This assumes you can find someone to pay you a very handsome price for the land.

Mr. **Sigler**. Yes.

Senator **Packwood**. How on earth could the buyer make a profit on the timberlands if the buyer is going to hold on to them long term?

Mr. **Sigler**. Most of the propositions are from someone who is putting together a package that hewill sell to institutions, on the basis that this would be a long-term appreciated value. I don't know anybody that has successfully put that together.

But I think it is a crazy proposal. You know, owning trees is one thing, but that asset has to tie in with either a solid wood converting operation or a pulp and paper operation.

Senator **Packwood**. There is no value in holding them just as a landowner for a long period of time?

Mr. **Sigler**. Only aesthetically.

Senator **Packwood**. I have got to go vote. Thank you.

Senator **Pryor**. Senator Packwood, I will hold the fort for a moment, then I imagine we will have to recess. I apologize to the witnesses for any inconvenience this may cause.

I would like to tell our distinguished witnesses that I was late for this hearing; I have gotten in very late in the whole process. I am sitting here going through a lot of papers and a lot of former questions that have been asked of our witnesses today, and I am trying to figure out the purpose of the legislation before us, and I am sorry I did not hear Senators Kassebaum and Dole.

Is the purpose of this to raise revenue or to slow down trades? What is the purpose of this?

Mr. **Buffett**. I think I can speak to that, Senator. I listened to Senator Kassebaum, and I have read her remarks, and I think the purpose is to enact a "non-tax" tax. It is to enact a tax that she hopes will not be collected but instead will result in behavior modification by the people who would otherwise incur it, and it is not in any respect designed to raise revenues. She has expressed herself clearly, I think, on that.

Senator **Pryor**. Well now, because I am a neophyte in this issue, have we ever taxed pensions?

Mr. **Sigler**. No. The money that is put aside under an accepted formula set out by the ERISA rules is put aside by the "plan sponsors"—the jargon for employers—on a pre-tax basis, and it is not taxed.

Mr. **Buffett**. Senator, if I might, I would add that the precedent for a non-tax tax exists. In effect, it is not payable to the Treasury but is payable to the corporate treasury. If an insider—officer, director, 10-percent holder of a company—trades his stock within a 6-month period and realizes a profit, he has to pay 100 percent of that to the company. Well, the effect of that is not to raise a lot of money for companies, it is to keep insiders from trading in a 6-month period, and it has been very effective.

We also had the Silver Purchase Act of 1934, which enacted a 50-percent excise tax on profits from trading in silver, and it ended speculation in silver, which was one of the purposes of the Act.

So the concept of a non-tax is not novel. But there would be some revenue, in my opinion, raised from Senator Kassebaum's proposal, simply because I do not think it would be as effective in behavior modification as she might hope.

Senator **Pryor**. I think I have time for one more comment.

I wear two hats around this place, not only being a member of this very fine committee but also being chairman of another committee, and that is the Aging Committee.

I think there are a lot of people out there in the aging community that are very concerned about such a proposal as this. For example, they have seen, like I have seen, some pension economists estimate that a 1-percent decrease in return on pension assets translates into about a 15 or 20 percent increase in contributions over the life of that plan. Is that a valid comment on the world of pensions, Mr. Sigler?

Mr. **Sigler**. Well, I think sometimes that comments such as that are intended to get people upset. Most pension funds are defined-benefit funds, which means that the contract to the pensioner is from the institution, i.e., the employer.

Champion has to pay you, as an employee, your retirement. We are required by law to put so-much of that money aside now to make sure that we have the ability to make future payments. If the investment of that money makes more than the numbers that we have in our projections, then we don't contribute as much in the next year. If it makes less, we, the company, contribute more in the future.

So, what a pensioner should worry about, and worry about very seriously, is the long-term viability of the institution that he has his contract with.

Therefore, I think you can make a strong case that all of this churning and all of this buying and selling isn't really the important thing to the person who gets the pension contract, the important thing is the long-term health of the company on their employer.

Senator **Pryor**. Mr. Sigler, we are down to about 4 minutes before I have to go to the floor. I am going to ask unanimous consent that my full statement be placed in the record. Seeing no one here to object, I wonder if either of you gentlemen might object? [Laughter.]

Mr. **Sigler**. Not at all.

Mr. **Buffett**. Not at all.

Mr. **Sigler**. I like your system. [Laughter.]

Senator **Pryor**. We will be in recess for 5 minutes. Thank you. [The prepared statement of Senator Pryor appears in the appendix.]

[Whereupon, at 3:12 p.m., the hearing was recessed.]

AFTER RECESS

Senator **Riegle**. Let me invite those in the room to find a seat. We are still in the middle of this roll call, so members will be coming back at different times; but I think we ought to make use of the time for our witnesses.

Mr. Buffett, let me ask you: You were very direct and explicit on the tax issue as a behavior modifier and what you think it might take to have an effect. Are there other options that we ought to be thinking about and ways of trying to create more of a longer-term investment mind set and behavior? What else should we be thinking about, whether in this committee's jurisdiction or elsewhere?

Mr. **Buffett**. Senator, you would like to think that education would do it. I mean, you would like to convince people that if they are taking 10 percent of all of the profits of their companies and spending it in chair-changing activity, that maybe that isn't a totally productive activity. But I have seen people try education for 50 or 60 years without much effect.

I think the tax law is the way to affect behavior.

I mentioned, during the interim, that in effect we have said to insiders who trade in the 6-month period that they have to give all the profit to the company under the Securities Exchange Act, and that hasn't raised a lot of money for companies, but it has certainly modified behavior.

I don't think there is anything more effective, that gets through faster to investors and to Wall Street generally, than the tax law. It was the first thing I read when I got out of school at Columbia when I was 20 years old. But you have got to make it very tight, because people are going to try to figure out ways to convert short term to long term, and all that sort of thing, which is one reason I am worried about the hedging section in the Kassebaum-Dole Bill. But if it is properly drawn and the rate is sufficiently high, you can affect their behavior. I don't know any other way to do it.

Senator **Riegle**. When you think about other market mechanisms and activities that increase volatility or that start to change the nature of the game—several things came to mind as you were talking before.

I know when you go back to that period before the market broke, portfolio insurance—you didn't name that as such, but you may have had that in mind—was one of those devices where a lot of people thought, you know, if the elevator car was up on the twentieth floor, you could have a way to make sure that when it started down you could get out at the nineteenth floor. We found out that didn't work, that a lot of people, by the time they figured it out, were down at the tenth floor or the eleventh floor and could not all get out at the same time. So there have been some corrections in that sense.

But are there other market practices or market activities today that one way or another seem to add to this kind of a problem, either to volatility or to churning, or that take us away from any kind of a longer-term perspective which would give the country good, solid, long-term economic results?

Mr. BUFFETT. Well, I think index futures on balance are a negative for investors and for society. In the fall of 1987, I believe they created the illusion of great liquidity, which gave rise to portfolio insurance because people had the idea that they could sell on a moment's notice. You had $60 to $90 billion worth of equities on a hair trigger.

If all of the farms in Nebraska were owned by farmers who, every time there was a down-tick on farm prices said, "Now I should sell off 5 acres; and if it goes down a few percent more tomorrow I should sell off some more acres," you would have a very volatile market in farm prices. Anything that induces such behavior would not be good for farmers or for our society.

In my opinion, the illusion of liquidity actually can lead to greater volatility and particularly to panics. If people are owning stocks not because they want to be an owner of a business but because they think that some system or some identifiable signal will tell them when to get out, and if you have any large amount so held—you saw what $25 billion worth of securities for sale did to a $3 trillion market on October 19, 1987; it took $600 billion off values, or close to it—it just won't work.

It is like a musical chairs game, where everybody walking around owns stocks, and the only way they can get out of those stocks is to get somebody else to take their place by vacating a chair. No matter how many chairs it looks like are available, if somebody has created a signal that says, "Look for a chair" so you know when all of the people are going to be running for chairs, you are going to produce very volatile markets.

The very fact that people knew that $60 to $90 billion were poised to sell on a decline meant that I and everyone else would know what was going to happen if the Dow was down 100 or 200 points, and it created its own momentum. It is like a fire that starts not because of a combustible element but simply because enough people start leaving their seats in the theater.

Senator RIEGLE. I know the Chairman is back, but just a couple of other things here, if I may.

The debate seems to be picking up steam, as to whether the SEC should take over the control of stock index futures from the CFTC.

Should I infer from what you said that if you are going to have stock index futures, they ought to be under the control of the SEC? Would that be your view?

Mr. BUFFETT. I would have that view. I would wish there weren't any index futures but, if they exist, I definitely think they ought to be under the supervision of one organization, and in my view that should be the SEC.

Senator RIEGLE. Let me ask you one other thing:

With respect to the large volume of leveraged buyout activity—I know this has been a concern to a company like Champion, and we have talked about it before—it is abating now, partly because the junk bond market has fallen. One of the reasons the junk bond market has fallen—I don't say the only reason—is we took the savings and loans out of the junk bond business, so that has also taken away the access to a lot of broker deposits which were coming through savings and loans that were making large investments in junk bonds, so it has just been one area that has been shut down.

But I am wondering if it is your view that that whole burst of leveraged buyout activity was, on net, good? Bad? Can you make a value judgment about it?

You know, we have got a lot of things that have been going on at once in terms of market mechanisms and philosophy, and short term versus long term, changes in tax laws, and so forth; but, Mr. Buffett, would it be your view, when you go back a year and a half, 2 years, 3 years ago—I mean, apart from your own investment philosophies, but in the aggregate, have we gotten ourselves into a situation where we are really working against ourselves, net, as a country, in terms of our economic future, in your view?

Mr. BUFFETT. I think it will turn out to be a net minus, but I don't think you can categorize them as all bad or 90 percent bad or 80 percent bad. I think it will turn out, over all, to be a net minus.

Senator RIEGLE. If that is the case, and I understand the caveat you put on it, what other things are there that we ought to be thinking about doing, with respect to the market structure, cost of capital, long-term investment, that in effect will give us a stronger and more well-sustained economic performance as a national economy as we go ahead? What other adjustments should we be thinking about?

Mr. BUFFETT. I would go further in tilting the tax laws than has been talked about here today. I think most of the Administration's proposals will probably lean toward more carrots, but I probably would have a fair number of sticks in there, too. So I would have a significant difference in short-and long-term tax rates, and it would tax all other presently tax-exempt institutions as well as pension funds.

It seems to me that tax exemption is a privilege and not a right. I have managed various tax-exempt funds. One of them was at Grinnell College, and 12 years ago we bought a television station in Dayton. We paid income tax on the income from that television station as it was operated. Even though it related to the investment funds of Grinnell, those earnings were "unrelated business income." And I think there might well be grounds for treating as "unrelated business income" the short-term trading of otherwise tax-exempt institutions.

Senator RIEGLE. Mr. Chairman, might I put that same question to Mr. Sigler and see if he has any other suggestions he wants to make to us?

The CHAIRMAN. Yes.

Mr. **Sigler**. From my perspective, I would like to see a phenomena that takes the people that own my stock out of the category of being "quick investors," and directs them to be people who are really long-term owners. Perhaps ERISA changes can do that.

I would agree with Warren that the futures and the derivative products shouldn't be there. I see nothing good that comes of them.

I think the only real mechanism that we have besides some modification of ERISA law which I think is important, is the tax law. I think the tax law can affect how people perform as owners, and I think the tax law has a tremendous effect on how I perform and how my company performs, on what I invest in and those sorts of things. So I think it is the one really powerful mechanism there is. Education doesn't work.

Senator **Riegle**. You both seem to agree on that. You seem to be making the same point.

Thank you, Mr. Chairman.

The **Chairman**. We have an unusual situation here where we have two committee chairmen. We have the distinguished chairman of the Banking Committee, and we have some expensive talent before us for free. We have found your testimony very interesting and most helpful. Thank you very much.

Our next witnesses are Professor Lawrence Summers, Professor of Political Economy, Department of Economics, Harvard University; and Professor Myron Scholes, Frank Buck Professor of Finance, Graduate School of Business, Stanford University. They are two very able and articulate advocates of their points of view. I think they will be quite helpful to us.

We appreciate having you, gentlemen.

Dr. Summers, would you proceed?

STATEMENT OF LAWRENCE H. SUMMERS, PH.D., NATHANIEL ROPES PROFESSOR OF POLITICAL ECONOMY, DEPARTMENT OF ECONOMICS, HARVARD UNIVERSITY

Dr. **Summers**. Thank you, Senator Bentsen.

I am delighted to have the opportunity to appear before this committee again and to discuss the important issue of using the tax system to limit short-term trading.

I believe this is a desirable goal; however, my analysis suggests that the proposals to raise the taxation of short-term capital gains as a vehicle towards that objective might well prove counter-productive.

In my testimony I want to make three points.

First, there are strong economic rationales for taxing short-term trading. They take three forms.

First, taxes on short-term trading would discourage what might be referred to as "positive feedback" investment strategies, strategies where you are in the market all the time, selling when the market goes down, buying when the market goes up, giving rise to positive feedback and increasing volatility. I think the illusion of liquidity created by low transactions costs had a good deal to do with the crash.

Second, transactions taxes, by discouraging short-term speculation, would divert resources from zero-sum gains to positive-sum gains. Mr. Buffett already commented on this. The estimates that I report there suggest that the cost of allocating capital, operating and running the financial system, may well exceed half of the level of net investment of American corporations, and that seems too much to devote to allocating those resources more accurately.

Third, shareholders who have an incentive to stay with companies for a long time are more likely to take an interest in the business and to focus on the long-term prospects for the business rather than the short-term prospects for the changing perceptions of American investors. In Albert Hirschman of Princeton's famous phrase, "They are likely to substitute voice for exit" when there is a problem with corporate management and thereby to improve performance.

I would suggest that, while transactions costs have come way down in the last 15 years and the volume of resources that are devoted to operating the financial system have gone way up, it is difficult to find the people who experience less risk or the companies who enjoy access to capital at lower cost than they did earlier, and that establishes at least some presumption that reducing the volume of resources that went into those transactions costs would improve the performance of the economy.

And we have a large budget deficit. All taxes discourage something, and it seems much more desirable to discourage short-term trading than to discourage work or to discourage saving as ordinary tax increases would.

How best to tax on short-term trading? I believe that the short-term capital gains approach is perilous, for two reasons:

First, one has to decide whether one is going to permit losses to be offset against gains in computing tax liability. If one does not permit losses to be offset against gains in computing taxes, one risks a very high effective tax rate. If the Government is my partner when I win and I am alone when I lose, then if there is a 55-percent chance that I am going to win and a 45-percent chance that I am going to lose, the tax that only kicks in when I win will take a large fraction of my expected return.

I think taxes that did not treat investors symmetrically would be likely to do great damage to liquidity in the marketplace. That is the principle we have always recognized with our capital gains taxes, allowing losses to be deducted against gains.

Suppose, then, that we do permit losses to be deducted against gains. The short-term capital gains tax runs into two problems:

First is what I would refer to as the "fair bet problem." Imagine that I was prepared to make a bet—I illustrate with the example of a bet—of a thousand dollars on the outcome of some event, in the absence of a tax. Now imagine that a 50-percent tax was imposed. With a 50-percent tax, if I now upped my bet to $2,000, I would be in exactly the same place that I was before. If I invested $2,000 and I won, I would keep $1,000; if my investment did not work out, I would lose $1,000. Because the Government was functioning as a silent partner, I would be induced to increase rather than to decrease the volume of my short-term speculation.

The second problem with the short-term capital gains approach is what might be referred to as "the straddle problem." And indeed, as the Joint Committee's pamphlet points out, short-term capital gains taxes have in fact been revenue losers in the past. They have been revenue losers because investors find ways to invest in two securities that are very likely to move in opposite directions, and sell the one that loses.

Now that is some problem at the level of individual investors. If one considers pension investors who have access to a broader array of securities, who have much lower transactions costs and are likely to be much more sophisticated, the potential for gaming of that kind is greatly increased.

I think a transactions tax, which warps without destroying market liquidity in Japan, Britain, Germany, and almost every other industrialized nation, is much the better way to go after short-term trading.

My time is nearly at an end. The last section of my testimony seeks to answer the arguments that it would destroy liquidity and drive business overseas.

The central point on liquidity is that it would simply restore the level of transactions costs in the marketplace to what it was in 1975, before we saw the tremendous reductions in transactions costs that we have seen in the last 15 years, and I don't think the market suffered great damage for lack of liquidity in the mid-1970s.

As far as driving trading overseas is concerned, a properly drawn tax need not have that effect; after all, a tax on capital gains applies whether I sell my asset in France or whether I sell my asset in the United States. A properly designed transactions tax would apply to the transfer of U.S. securities wherever that transfer took place, and to that extent it would not encourage trading to move overseas anymore than even the advocates of capital gains reductions do not make the argument that it drives trading overseas.

I think there is a strong case for curbing short-term trading, but the transactions tax is far preferable as a means to that objective, to the capital gains approach.

Thank you very much.

The CHAIRMAN. Thank you.

[The prepared statement of Dr. Summers appears in the appendix.]

The CHAIRMAN. Dr. Scholes?

STATEMENT OF MYRON S. SCHOLES, PH.D., FRANK BUCK PROFESSOR OF FINANCE, GRADUATE SCHOOL OF BUSINESS, STANFORD UNIVERSITY, PALO ALTO, CA

Dr. SCHOLES. Thank you, Mr. Chairman.

I appreciate the opportunity to testify on the implications of imposing transactions costs of various forms to dampen the short-term trading activities of our pension funds and other investors in our securities market.

In my view, the cost to society of a transaction tax outweigh the presumed benefits. I predict that the liquidity in our markets will decline, and as a result the market values of securities must also decline. The market will become less efficient in incorporating information into securities prices, and the net result will be an increase in the cost of capital to U.S. corporations.

Baffling as it may seem, even though investors will hold securities longer, a transaction tax does not encourage our corporations to invest for the long run, for an increase in their cost of capital will cause them to take even shorter-term projects than they currently do.

With the Senators Dole and Kassebaum bill, the plan is to tax short-term trading gains of pension funds. To tax short-term gains differently from long-term gains is nothing new in our tax code; but the difference here, as Professor Summers has said, is that the short-term gains will not be netted against short-term losses, and this will cause various investors who are really long term to be caught by the tax itself. They will be forced to undertake costly hedging transactions to convert short-term into long-term gains.

Even if the bill's stated intention is not to raise revenue but to direct attention of pension plan sponsors to the unnecessary churning of their portfolio managers, I believe that sponsors already know about the turnover policies of their fund managers, and I don't see that there is going to be much added to their knowledge base.

If a transaction tax does provide incentives to hold long term, just as the capital gains tax with rate differential, it avoids the lock-in effects of waiting 6 or 12 months, or whatever, to achieve long-term status. And a transaction tax also reduces the cost of trying to convert short-term into long-term gains by using the many tricks that were so common prior to the 1986 Tax Act.

Transaction taxes and capital gains taxes increase the cost of capital to U.S. corporations. Even if President Bush succeeds in his plan to reduce the capital gains tax, the imposition of a transaction tax will offset the benefits of such a reduction; transaction taxes are in effect substitutes for capital gains taxes.

U.S. corporations have taken shorter-term investments, in my belief, because their cost of capital is now greater than in the past. Real interest rates have increased.

Moreover, the 1986 Tax Act increased capital gains taxes and increased the corporate cost of capital. When capital costs are higher, longer-term cash flows are not as valuable, and corporations naturally take shorter-term projects. We should applaud their behavior and not criticize them for taking shorter-term views; they are preserving our scarce capital.

Foreigners have lower costs of capital and can take the longer view. Moreover, because of tax laws and because it is more expensive for corporations to produce in host countries than in home countries, foreign investments that are made in the United States are skewed towards those that require longer investment horizons. Subtly, this natural skewing of the investment choice makes it appear that foreigners investing in the United States are investing for a longer period, on average, than we are, because we take all investments.

If managers are truly myopic and make mistakes because they direct their attention to short-term trading in the market, then a transaction tax will make things worse than better.

First, we should not protect managers who take a short-term view if it is economic for them to take a long-term view. Those that take a long-term view will prosper; those that don't will fall by the wayside.

It is true that some worry that if they take a long-term view, and produce earnings that are low because their R&D projects or long-term investments result in high start-up costs, their stock price will fall, and they will be taken over by others. If this were really the problem, the market can take care of this without Federal assistance; but I think it is a false assumption.

A great number of papers in economics and finance and accounting literature indicate that the price fall-offs on unexpected bad-earning announcements are permanent and signal that future earnings, too, are going to be lower than expected. So we have an identification problem. Managers might think the prices fall off of others because they announce projects; but I think that the efficient market's view says that the market predicts accurately what is going to happen, on average.

Second, a transaction cost will reduce market liquidity. In a reduction of liquidity, investors require higher rates of return.

The evidence is clear that illiquid assets require higher rates of return than liquid assets. Markets such as the New York Stock Exchange are in the business of providing liquidity services for investors. With a fall in trading activity, the cost of providing these services will increase. As a result, the bid-ask spread, the price at which we can buy and sell securities, will widen in our market. This will, again, increase the cost of capital to U.S. corporations and fragment our market, as U.S. investors may achieve the same liquidity services abroad or select other investments that are not subject to the tax.

In conclusion, transaction taxes, even at what appears to be a very low rate, can have strong real economic effects. Even John Meynard Keynes, who likened the securities market to a casino, argued that liquidity services were crucial to investors; and though he favored a transaction tax to make investors hold securities longer, he realized the importance of liquidity and therefore voted against it.

Thank you very much.

[The prepared statement of Professor Scholes appears in the appendix.]

The CHAIRMAN. Dr. Scholes, you testified that pension funds invest for the long term, that their holding periods for equities average many years, and that their turnover rate is lower than the market as a whole.

If that is the case, why does the Kassebaum-Dole bill concern you?

Dr. SCHOLES. It concerns me because many of the transactions that are made by pension funds to try to increase trading profits for investors provide liquidity to the market, and if one is constrained as to their trading, that will reduce liquidity and liquidity services in the market.

In addition, I think it will also mean that pension funds will substitute away from holding of securities into other assets if they are allowed to do such.

The CHAIRMAN. I understand the FEI favors a capital gains preference to encourage long-term investment. And yet, they appear to oppose a penalty on short-term investment. Isn't that a contradiction?

Dr. **Scholes**. I'm sorry, I missed the first part of your statement, Senator.

The **Chairman**. My understanding is the FEI supports a capital gains preference.

Dr. **Scholes**. What supports it? Oh, I'm sorry; I wasn't aware of the pneumonics.

The **Chairman**. That isn't correct?

Dr. **Scholes**. No, I didn't understand what the pneumonic meant.

The **Chairman**. I was referring to the Financial Executives Institute.

Dr. **Scholes**. I haven't had a chance to read their statement, Senator. I just picked it up a moment ago.

The **Chairman**. All right.

Larry, you pointed out that Japan's turnover rates are substantially higher than ours. Is that correct?

Dr. **Scholes**. That is correct.

The **Chairman**. Even though Japan has a transaction tax.

Dr. **Scholes**. Yet, they have reduced their transaction tax, over time.

The **Chairman**. West Germany also has a transaction tax, but their turnover rate is also higher. Would you address that, Dr. Summers?

Dr. **Summers**. I think the question you want to ask is what would turnover in Japan be if they had a lower transactions tax, and I think if we had had in the United States a kind of run-up in our market that they have had—you know, it has tripled in the last 4 years and it is up twentyfold in the last 15 years—if we had had that kind of return on our market, we would have had exactly the same kind of psychology.

We had an experiment like that. Turnover was very high in 1987, and turnover was very high in the late 1920s. So I think the way to understand the Japanese turnover is that it is really in spite of the transactions tax and not because of the transactions tax, and it is a feature of the spectacular performance that that market has had, and it is related to the fact that, with the personal saving rate that is several times ours, there are just a lot more Japanese households who get their kicks playing in the stock market than there are American households who get their kicks that way.

I don't really know what the answer is with respect to the West Germans; but, again, I would think that the question one really wanted to ask is, in those countries how would the turnover be different if there were no transactions costs or if there were no transactions tax.

The **Chairman**. Would it depress the price of the stocks?

Dr. **Summers**. I don't think that is clear at all. The evidence, basically, for that proposition comes from saying if we take some stocks where the market doesn't function very well, and we assume that that transactions cost is capitalized into the price, then the price will be lower. But I think that neglects the possibilities that the market would improve performance. The estimates of that kind take no account of the possibility that variants of the market—

which is one of the things that determines return—would fall in the presence of a transactions tax. It takes no account of the possibility that corporate managers would increase profits by working more for the long term in the presence of a transactions tax.

My guess is that, for the overall level of the market, the kinds of transactions taxes that one would be talking about, that would raise $2-$3 billion a year, would be completely lost in the noise, in terms of measuring the effect on the market. I wouldn't want to argue that it would send the market way up, but I think it would be very wrong to suppose that the market would go way down.

It is certainly not true that price/earnings ratios or other measures like that are systematically higher with the more liquid market we have today, relative to the degree of turnover that we had 15 years ago that you cited in your opening statement.

The CHAIRMAN. Dr. Scholes, do you think there really is a trend toward short-term trading? Do you think it has had a negative effect on long-term investment decisions of American management?

Dr. SCHOLES. I don't think it has a long-term effect. I think, in some sense, the turnovers we have seen now, compared to in the Seventies, were the result in part of the reduction in transaction costs that have occurred in markets. We have had a change from fixed commissions to variable commissions and negotiated commissions, and commission rates have been reduced quite dramatically for investors to alter their holdings.

As you reduce the cost of trading and the presumption that individuals can adjust their portfolio holdings to their desired amounts, then it is the case that they are more attractive to the instruments, of stocks that themselves are supporting and bolstering long-term capital formation in this country.

So, "too much trading" or "too little trading" is hard for me to define, because I don't know what the numerate is; I don't know how much trading we should try to protect or how much trading we should try to foster in our society.

Individuals do turn their portfolios over and make adjustments. Any rule that tries to prevent trading or reduce transfers or trading itself has other effects; one is, it reduces the liquidity services that exchanges can provide. It also induces individuals to seek other investments that are liquid, and investors demand liquidity.

I know there are many examples where investors shy away from illiquid investments or require higher rates of return than liquid investments, and I don't know what we are trying to accomplish by reducing what the cost of having this turnover really is. I think it really is a benefit to society to allow people to adjust their portfolio holdings in the way they want.

The CHAIRMAN. Do you think that is the basic flaw in the thinking, of people like Nobel Prize Winner Tobin Dr. Choate and your friend Dr. Summers?

Dr. SCHOLES. Well, I respect them very much and over the years have learned from them; and Professor Summers and I have disagreed in the past, so it is not as though this is new.

But is interesting to me that Professor Tobin's views and others' views are that the only thing that is good in society—I am making an extreme statement here—is if we use our energies and individuals to produce only goods and services, and goods in particular.

We have huge information costs in society, where many people dealing in the securities markets and providing support and information to others are just very valuable.

If everyone knew everything, then there wouldn't be a demand for teachers or educators such as Professor Summers and myself, and I think in a lot of ways we have reduced the staffs that were available to support the activities of Senators.

So, it is one thing to say how many people should be in industry and how much, but it is another thing to say what we should be doing.

So I really believe it is very hard to make statements as to define how many individuals should be in a profession, or whether it is good for society to have us providing financial engineering or financial services, just as it is how much education we should be providing or how big the fins should be in our automobiles.

The CHAIRMAN. Do you feel that way about the number of lawyers? [Laughter.]

Thank you very much, Dr. Scholes and Dr. Summers. We appreciate your testimony.

Our next panel will have as its members Mr. Robert Shultz, who is the Co-Chairman of the Working Group on Taxation for the Committee on Investment of Employee Benefit Assets, Financial Executives Institute, from Atlanta, GA; and Mr. Michael McGrath, Treasurer for the State of Minnesota, testifying on behalf of the National Association of State Treasurers and the Council of Institutional Investors; from St. Paul, MN.

Gentlemen, we are pleased to have you. Mr. Shultz, would you proceed?

STATEMENT OF ROBERT SHULTZ, CO-CHAIRMAN, WORKING GROUP ON TAXATION, COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS, FINANCIAL EXECUTIVES INSTITUTE, ATLANTA, GA

Mr. SHULTZ. Yes. Thank you, Mr. Chairman.

I am testifying today on behalf of the Committee on Investment of Employee Benefit Assets, commonly called CIEBA, of the Financial Executives Institute.

CIEBA is comprised of 36 corporate pension plan sponsors who invest almost $300 billion on behalf of 8.5 million plan participants. I personally have managed four major pension funds since the passage of ERISA in 1974.

We appreciate the opportunity to participate in today's hearing, and both the FEI and CIEBA are prepared to work with you and the staff on today's important issues.

The issues of global competitiveness of U.S. corporations and capital markets, which these tax issues ultimately impact, are critical to the private pension system.

The CIEBA members do not accept the characterization of our investment practices with phrases such as "excessive churning" or "speculation" and believe that the proposed legislation is an inappropriate response to the undue short-term orientation of U.S. corporations.

The linkage is supported only by anecdotal evidence that institutional investors and pension funds, in particular, are short-term traders and thereby force managements to focus on the short term.

A major systematic survey of CIEBA members' investment practices, as reported in yesterday's Wall Street Journal and in the hearing material, shows that the equity portions of our pension funds have turnover rates of about 40 percent annually, and that means that on average our stocks, any particular stock, is held for approximately two and one-half years.

The survey also shows that the tenure of the average investment manager assisting in running our funds is almost 8 years, and for those that are terminated, over 50 percent of the reasons are for non-performance reasons.

We submit that this picture is not one of a "churning speculator firing managers on quarterly performance records" that some in the media and in Washington, and at the hearing, have painted.

In addition, fully 34 percent of our equity holdings are currently managed in passive index funds with very low turnover. Clearly, the turnover of the active managers we employ must be looked at in the context of this total strategy.

I should note that, while we in the aggregate are not "short-term traders," the CIEBA members are not opposed to and indeed question the definition of the term. Most strategies followed involve projecting earnings and dividends years into the future, and then comparing the fundamental value to the current market price.

Although trading may well occur when prices vary from the fundamental value, the process is based on the long-term outlook for the particular company. This kind of trading performs a valuable function in the market: liquidity is enhanced, and volatility is reduced by returning market prices to fundamental values.

I would add that those plan sponsors and investment managers who trade in excess of their ability to add value very quickly pay the price by generating low returns caused by the cost of trading in that manner.

The proposed tax will not address what we feel are the real reasons for corporate short-sightedness, the major being the relatively high cost of capital, and the second being the threat of a takeover.

High real interest rates lead managers to favor projects with short horizons and rapid paybacks. If the liquidity in our secondary markets is impeded by the imposition of a tax, investors will demand a higher return, thus exacerbating the cost of capital issue that, as Secretary Brady explained, is so critical to U.S. corporations in the global arena.

Our prime concern is that the proposed tax would open the door to higher taxation of pension funds when the corporate short-sightedness problem is not solved, and other taxes could be imposed for other reasons.

If the tax becomes more onerous, there could be serious consequences for the pension system as a whole,because as benefits become more expensive to provide, corporations will naturally supply less.

A tax on many funds is not an invisible tax; fully one-quarter of all plan assets are in so-called "defined contribution plans," where the impetus of a tax would be felt directly and unambiguously by employees. One-third are in State and local plans, which would subject taxpayers to the increase, and 7 percent are in a jointly-trusteed plan where, again, the tax falls directly on the participants.

Although our tax incentive—and we are guilty of this, as well—is often termed a "tax exemption," it is in reality a tax deferment, as payments are eventually taxed when paid to fund beneficiaries.

In summary, we are opposed to this legislation and urge more systematic study of the issues, with evidence based more on facts and not on anecdotes.

We see two major over-arching issues that need to be dealt with. The primary issue, what has been talked about throughout the hearing, is the adjustment to the institutional ownership of America's corporations. And related to that is the capital market structure necessary to maximize U.S. competitive positions. I think both require significant dialogue, and neither should be or will be solved by taxing pension funds.

The private pension fund system is vital to U.S. workers. In 1988 the private pension system paid out $137 billion in benefits, nearly equal to Social Security's $148 billion.

I might add in closing, that as I have listened to all of those at the hearing today, I think we have a problem in the way we are focusing on this bill. Everyone has talked about this bill as focusing on equity investments but yet, if one carefully reads this bill, the bill applies to all assets, not just equity. So keep in mind that trading of even Treasury Bills and Treasury Bonds would be impacted, and any gains would be subject to the tax.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Shultz appears in the appendix.]

The CHAIRMAN. Well, if the bill applies to debt instruments, I would very much agree with you on that part of it.

Mr. McGrath?

STATEMENT OF MICHAEL A. McGRATH, TREASURER, STATE OF MINNESOTA, TESTIFYING ON BEHALF OF THE NATIONAL ASSOCIATION OF STATE TREASURERS AND THE COUNCIL OF INSTITUTIONAL INVESTORS, ST. PAUL, MN, ACCOMPANIED BY HOWARD BICKER, EXECUTIVE DIRECTOR, MINNESOTA BOARD OF INVESTMENT

Mr. McGRATH. Thank you, Mr. Chairman.

I would request that my full statement, submitted previously, be included in the record, so that I can simply summarize my remarks.

The CHAIRMAN. It will be done.

Mr. McGRATH. With me today also is Mr. Howard Bicker, who is Executive Director of the Minnesota State Board of Investment.

The CHAIRMAN. All right.

Mr. McGRATH. I am appearing today on behalf of the National Association of State Treasurers, NAST, and the Council of Institutional Investors. In addition, I am speaking on behalf of the Government Finance Officers Association and the National Association of State Retirement Administrators.

NAST represents State treasurers in all 50 States. The Council of Institutional Investors includes over 50 member groups representing city, State, police and fire, and union pension funds. GFOA represents local finance officials; NASRA is the professional organization for retirement administrators.

State treasurers invest pension assets worth $660 billion. The Council represents $300 billion in invested pension assets. Now, being a member of the last panel on a long day, my remarks must be sort, but not short term, and I will limit myself to a few brief points:

As State Treasurer in Minnesota, I serve as one of five Statewide elected officials, including our Governor, as a member of the Minnesota State Board of Investment. I also serve, by Governor's appointment, on the Minnesota State Retirement System Board of Directors.

The Retirement System in Minnesota administers eight Statewide retirement programs serving approximately 200,000 public employees, including teachers, State employees, local government employees, police and fire, highway patrol, and judges.

The value of Minnesota's combined assets was $15.5 billion at the end of last year.

The groups and individuals I represent are very concerned about the proposal to tax the short-term capital gains of our funds. However, I want to be very clear: we in general share your concerns about improving the long-term investment horizons, as viewed by managers of our nation's financial assets. However, we believe that the proposals being discussed today, while well-intentioned, are a simplistic solution to a complex problem.

In short, we do not believe the proposals will do much to achieve their desired policy goal of improving our international competitiveness. What they will do is exacerbate an existing problem of under-funded public pension funds.

For example, the Minnesota State Retirement System board, based on actuarial assumptions, is presently funded to meet 72 percent of our commitments; or, in other words, it is 28 percent underfunded in our commitments to our constituency.

Even without the imposition of taxes such as are envisioned under this proposal, our long-range target for fully funding our Minnesota Plan is the year 2020.

Proposals to tax the short-term gains on public pension funds would shift even more responsibility for meeting this commitment onto the already overburdened State and local taxpayers.

For those public pension funds that passively manage the majority of their assets, the proposed tax would impose a particularly unfair burden.

To replicate the market return, which is the goal of those indexed funds, periodical rebalancing results in buying and selling assets. There is no attempt to beat the market, but these transactions would still be subject to taxation if they are accomplished within the 30-day or the 180-day time periods.

NAST has only recently begun to examine this issue, while the Council of Institutional Investors has examined the issue closely and has reached the following conclusions:

First, there appears to be a misunderstanding of the basic assumptions of our investment philosophy. We understand that no investors have a more critical need for a long-term perspective than our pension funds. Our fiduciary responsibility under the law is solely to provide promised benefits to our individual members.

Second, and with this legal burden in mind, we do not madly flip our portfolios over by the minute like short-order cooks in a pancake house. The Council has submitted to you turnover and holding period data for Council members, and the numbers speak for themselves. We pull market averages down, not up; and our turnover has decreased in each of the last 2 years despite drastically lower transaction costs.

To give you one typical example: The giant New York City funds have held over 69 percent of their equities for more than six years each and have held their largest holdings for over 20 years each.

It is suggested, despite significant data to the contrary, that we are not only short-term oriented, and sack our managers if performance lags for even a quarter, but that our short-term perspective prevents American companies from pursuing long-term plans and thus harms our international competitiveness. If this were true, we would be the first to complain.

We have submitted numerous well-respected studies to you documenting that

Investors do strongly value a company's long-term potential;

Indeed, they tend to have a longer-term outlook than most corporate executives; and

The investment time horizons of investors, whether long or short, almost invariably do not affect, positively or negatively, corporate planning capacity.

The CHAIRMAN. Could you repeat that?

Mr. MCGRATH. The investment time horizons of investors, whether long or short, almost invariably do not affect, positively or negatively, corporate planning capacity.

The CHAIRMAN. Are you saying that it does not affect the long-term investments of corporate managers, whether turnover is high or low? Is that your statement?

Mr. MCGRATH. That is my statement.

The CHAIRMAN. How do you know that?

Mr. MCGRATH. I don't know it as personal information. It has been provided to me, though, based on information gathered by the Council of Institutional Investors.

The CHAIRMAN. I would like to know the basis of that information.

Mr. MCGRATH. We can certainly provide that, Senator.

[The information referred to above along with Mr. McGrath's prepared statement appear in the appendix.]

The CHAIRMAN. That is important, because I have received contrary evidence. I would like to understand your argument.

Mr. Shultz, you suggest that most pension funds are really investing for the long term, that their holding periods for equities average many years, and that their turnover rates are lower than for the market as a whole.

Mr. Shultz. That is correct.

The Chairman. If that is so, why are you so disturbed about the Kassebaum-Dole Bill, which just affects short-term trades?

Mr. Shultz. I will answer that in a couple of ways:

One, in both the statements that I made and I think that Dr. Scholes made, we are disturbed because of the market impact costs of imposing holding periods on the capital markets. I think the history of holding periods has not been one that is shown to be entirely positive in terms of the adequate efficient functioning of capital markets.

The other major issue that concerns pension funds particularly, and we have heard this today, is that pension funds have not up to this point in time been taxed, and there is a long history of support for the tax deferment of pension funds. We view this as a possible intrusion into that tax deferment which could have serious consequences if carried further in this domain.

I think one of the points I would add to that: with the number of pieces of legislation—pension plan termination and reversion legislation, the joint trusteeship of single-employer plans, this particular bill—there are a number of pieces of legislation that we are fearful may unwittingly cause the nation's pension fund system to move from defined-benefit plans to defined-contribution plans, and I think there is agreement amongst most parties that the defined-benefit plan is the best for the American workers.

The Chairman. Does the FEI favor a capital gains preference?

Mr. Shultz. I represent the CIEBA committee; I am not entirely positive of the exact position. I think they, in general, endorse a capital gains preference; that is correct.

The Chairman. And that is to try to influence investors and their behavior, isn't it?

Mr. Shultz. On this I am not giving FEI's position; I am giving my own. I would characterize the emphasis on capital gains as one of the efforts to promote investment in this country versus consumption and a way in which we can promote savings. Right now the pension funds are the major savers in this country, and I think we need the active participation of individuals in this process. So on that basis, I think capital gains—any incentives to invest are proper.

I think in my own mind I separate the imposition of holding periods for capital gains, be it 6 months, 12 months, or other, as dividing that into two separate issues, that one can support incentives for capital gains——

The Chairman. Can one support a capital gains preference, while opposing a tax on short-term capital gains?

Mr. Shultz. Yes. And I am also saying that I am not certain that holding periods with respect to capital gains have proved successful at any time in history. In other words, I am supporting capital gains reduction; but one can look at that as two issues: as a reduction in tax for capital gains, and one can look at the holding period requirements as another facet of that same issue.

The Chairman. But most people I have talked to, intertwine them.

Mr. SHULTZ. Yes, they do.

The CHAIRMAN. Mr. McGrath, I am looking at some incredible turnover rates. What do you think is a reasonable turnover rate for a pension fund management group?

Mr. MCGRATH. Senator, in Minnesota we average somewhere between 25 and 35 percent, and that is very good measured against the market as a whole.

The CHAIRMAN. Well, that is low. But, I am looking at a whole list of them. Here is one, 400 percent; another, 368 percent; 313; 340; 286; 264; 251; 284; 215—an incredible list of them. So it seems to me that there is abuse by a substantial number of investment managers.

Mr. SHULTZ. Mr. Chairman, I may be out of turn here, but I believe I know the source of that data, which is in fact investment managers and not pension plans, either public or private.

The CHAIRMAN. But I am not separating the two; this includes, as I understand, both public and private.

Mr. SHULTZ. Yes, but if you will bear with me, I believe the point—if we are talking the same data, from 13(d) filings of investment managers—I believe those firms with the 400 percent or approaching 400 percent turnover, if that is studied, are specialist firms on the New York Stock Exchange. I believe Spears, Leeds and Kellogg is one of those up on the top range.

In other words, what I am saying is, without definitive evidence to support that, I don't think any of those four or five top firms with a very high turnover are firms that manage institutional pension fund assets.

The CHAIRMAN. That may be right.

Mr. MCGRATH. Senator, might I invite Mr. Bicker to comment on that?

The CHAIRMAN. Yes.

Mr. BICKER. Mr. Chairman, the one thing I think should be made very clear is that the turnover numbers that a lot of people have used can be abused.

I can't really speak that much for the corporate plans, but the public pension plans—and I have been in this business for approximately 20 years—have turnovers in the twenties.

We are not the problem that is attempting to be corrected here. The fact is, to the Congress, Mr. Sigler in his testimony and Mr. Buffett in his testimony said, "We want owners, not short-term investors." And I think corporate America probably is getting to the point where they are getting a little sick of us being owners, because we are exerting our influence as owners.

The CHAIRMAN. Mr. Bicker, I think that is fine. When I asked that question of Warren Buffett, he said that managers would prefer that to have Cocker Spaniels, as opposed to German Shepards.

Mr. BICKER. That is correct. And we believe that very much.

The CHAIRMAN. Well, I don't quarrel with that; I think that is fine.

Mr. BICKER. But if you don't quarrel with that, we—again, "we" as public pension plans; I defer to Mr. Shultz for the corporate side of the equation—we believe we have to be long-term investors. We don't have an option to be a short-term investor and invest multibillion dollar plans, which is what public pension plans are.

The CHAIRMAN. Too often I think management gets pretty complacent and needs to be shaken up, not just by an LBO but someone that is a long-term investor who is concerned and wants to stay in it, rather than someone who just buys and sells the stock and says, "Well, I don't want to fool with that," and moves on.

Mr. BICKER. We agree with you, Senator, wholeheartedly.

The CHAIRMAN. Well, on that point, with someone having agreed with me, I want to say that I appreciated the testimony. Thank you very much. It was helpful.

That concludes the hearing.

[Whereupon, at 4:21 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF SENATOR LLOYD BENTSEN

Heads of large U.S. corporations tell me that short-term market behavior is tying their hands when it comes to making good investment decisions. They tell me that as soon as they announce a long-term investment project that will divert earnings in the short run, institutional investors promptly dump their stock. The corporation's stock price falls, possibly inviting a takeover bid. Faced with this sort of pressure, these businessmen say it takes a staunch resolve to undertake any long-term projects.

Turnover rates in the New York stock exchange have increased substantially in the past three decades. Turnover was only 19 percent in 1970, and now it's over 50 percent. since deregulation of the brokerage industry, commission costs for trading have declined enormously. For large institutional investors, commissions today can be as low as 3 or 4 cents per share. Add to that the fact that many institutional investors are tax-exempt, so that there is no tax cost to repeated trading, and you can see there is little to dissuade short-term trading behavior.

I'm deeply concerned that we have too many investors looking too much at the next quarterly earnings report—and not giving much thought down the road. I've been in business so I know that good management means striking a balance between short and long term strategies. But if the markets are pressuring managers into looking only to the near term, that bodes ill for our country's future economic growth and prosperity.

I want this hearing to address the following questions: do the statistics show a marked trend toward short-term trading behavior? If so, what are the effects of such a trend on the business decisions of our country's corporate managers? Should the Congress intervene, and if so, what is the appropriate response?

We have an excellent line-up of witnesses today to address these issues. Treasury Secretary Brady is with us today to share his views. He and I have long shared a concern over the short-term horizons of much of U.S. business activity. We also have two prominent businessmen, Warren Buffett and Andrew Sigler, here to give is their perspectives. We will hear from two prominent economists, Larry Summers of Harvard, and Myron Scholes of Stanford. And, finally, we will hear from representatives of associations with expertise in pension fund management.

SUBMITTED BY SENATOR LLOYD BENTSEN

[JOINT COMMITTEE PRINT]

TAX TREATMENT OF SHORT-TERM TRADING

SCHEDULED FOR A HEARING

BEFORE THE

SENATE COMMITTEE ON FINANCE

ON MARCH 21, 1990

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

MARCH 19, 1990

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INTRODUCTION

The Senate Committee on Finance has scheduled a public hearing on March 21, 1990, on proposals relating to the Federal tax treatment of short-term trading on long-term investments, including S. 1654 (introduced by Senators Dole and Kassebaum). S. 1654 would impose a tax on the short-term gain realized by pension funds having over $1 million in assets.

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides an overview of present and prior law provisions related to taxation of short-term trading (Part I), a description of proposals (Part II), and a discussion of issues relating to the tax treatment of short-term trading (Part III). The Appendix provides information relating to certain foreign countries' taxation of short-term trading.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Treatment of Short-Term Trading* (JCS-8-90), March 19, 1990.

I. PRESENT AND PRIOR LAW

In general, present law does not impose any Federal income tax surcharge or excise tax on the income derived from the sale or exchange of an asset held for a short period of time. Net gains on the sale or exchange of an asset are taxed as ordinary income, regardless of the length of time the asset is held. There are rules under present law, however, that limit the ability of certain entities to derive a portion of their income from short-term investments. In addition, the Securities and Exchange Commission imposes fees with respect to certain securities transactions.

Under prior law, excise taxes were imposed on certain issuances and transfers of securities. In addition, there was a tax preference accorded to long-term capital gains prior to the Tax Reform Act of 1986.

A. Present Law

1. Taxation of short-term trades of RICs and REITs

In general, a regulated investment company (RIC) and a real estate investment trust (REIT) are entities that invest in specified passive investments and meet other requirements. A RIC or REIT generally is subject to a corporate-level tax but receives a deduction for dividends paid to shareholders.

To qualify as a RIC, a company must derive less than 30 percent of its gross income from the sale or other disposition of stock or securities held for less than 3 months. To qualify as a REIT, an entity must derive less than 30 percent of its gross income from the sale or other disposition of (1) stock or securities held for less than one year, (2) property sold in a prohibited transaction, or (3) certain real property held for less than 4 years.

2. Unrelated business income tax (UBIT) and the taxation of portfolio income

The Internal Revenue Code provides tax-exempt status for a variety of entities, such as charitable organizations, social welfare organizations, labor unions, trade associations, and qualified pension funds. Tax-exempt organizations, however, generally are subject to tax on their unrelated trade or business income. The unrelated business income tax (UBIT) is imposed on gross income derived by a tax-exempt organization from any unrelated trade or business regularly carried on by it, less allowable deductions directly connected with the carrying on of such trade or business, both subject to certain modifications.[2] An unrelated trade or business is any trade or business the conduct of which is not substantially related (aside from the organization's need for revenues) to the organization's performance of its exempt functions.

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[2] The UBIT generally is levied at the corporate tax rates; in the case of charitable trusts, it is imposed at the individual tax rates.

The UBIT generally does not apply to certain types of "passive" investment income (unless derived from debt-financed property[3]), such as dividends, interest, royalties, rents,[4] and gains from disposition of property other than inventory or property held primarily for sale to customers in the ordinary course of a business (sec. 512(b)). Also excluded from the UBIT are gains on the lapse or termination of options to buy or sell securities, written by a tax-exempt organization in connection with its investment activities (sec. 512(b)(5)).[5]

Thus, if a tax-exempt organization owns stock in a corporation, dividend payments received by the organization generally are not subject to the UBIT (unless the organization's purchase of the stock was debt financed), regardless of whether the corporate activities giving rise to the dividend income are related to the organization's exempt functions. In addition, any gain realized from the sale or other disposition of such stock by the tax-exempt organization generally is not subject to the UBIT.

3. Rules relating to pension plan investments

In general

The labor law provisions of the Employee Retirement Income Security Act of 1974 (ERISA) contain rules governing the conduct of fiduciaries of employee benefit plans. ERISA has general rules relating to the standard of conduct of plan fiduciaries and also contains specific rules prohibiting certain transactions between a plan and parties in interest with respect to the plan, such as a plan fiduciary. Plan participants, as well as the Department of Labor, may bring suit to enforce the fiduciary rules. Plan fiduciaries are personally liable under ERISA for any losses to a plan resulting from a breach of fiduciary duty. A court may also impose whatever equitable or remedial relief it deems appropriate for a violation of the fiduciary standards.

The Internal Revenue Code does not contain extensive fiduciary rules. However, in order for a plan to be qualified under the Code, a plan is required to provide that the assets of the plan be used for the exclusive benefit of employees and their beneficiaries. In addition, the Code contains rules prohibiting transactions between a plan and disqualified persons with respect to a plan that are similar to the prohibited transaction rules under ERISA.

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[3] The term "debt-financed property" means property (the use of which is not substantially related to the performance of the organization's exempt function) held to produce income with respect to which there is an acquisition indebtedness during the taxable year, or during the 12 months prior to disposition if the property is disposed of during the taxable year.

[4] Interest, royalties, and rents (but not dividends) paid to a tax-exempt organization by an 80-percent-owned entity are subject to the UBIT in proportion to the income of the controlled entity that would have been subject to the UBIT if derived directly by the controlling tax-exempt organization (sec. 512(b)(13)).

[5] However, income from securities purchased on margin generally is considered to be debt-financed property income subject to the UBIT. *See Elliot Knitwear Profit Sharing Plan v. Comm'r*, 71 T.C. 765 (1979), *aff'd*, 614 F.2d 347 (3d Cir. 1980).

Exclusive purpose rule; prudence standard

The general fiduciary standard under ERISA requires that a plan fiduciary discharge his or her duties with respect to a plan (1) solely in the interest of the plan participants and beneficiaries, (2) for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable administrative expenses of the plan, (3) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, and (4) in accordance with the documents and instruments governing the plan to the extent such documents and instruments are consistent with ERISA.

The prudence requirement is the basic rule governing the standard of conduct of plan fiduciaries, and it is against this rule that actions of plan fiduciaries are generally tested. A plan fiduciary does not violate the prudence standard merely because one investment bears greater risk of loss than others; rather, the prudence standard requires an evaluation of the investments of all assets in the aggregate. The prudence standard charges fiduciaries with a high degree of knowledge. This standard measures the decisions of plan fiduciaries against the decisions that would be made by experienced investment advisors. For this reason, some plan fiduciaries hire professional asset managers to invest plan assets.

Other than the prohibited transaction and self-dealing rules, neither the Code nor ERISA contains specific limitations on the types of investments a pension plan may make.

There has been some concern that ERISA's fiduciary rules require pension fund managers to automatically sell stock held by their funds in response to any above-market prices offered for the stock, rather than consider the long-term investment potential of the stock. In response to such concerns, the Treasury Department and the Department of Labor issued a joint statement on January 31, 1989, reiterating the duties of pension plan fiduciaries.

This statement provides that investment decisions, including tender offer decisions, must be based on what is in the economic interest of the pension plan, recognizing that the plan is designed to provide retirement income. Such decisions are to be based on the facts and circumstances of the particular plan.

The statement provides that, in evaluating a tender offer, it would be appropriate to weigh a tender offer against the underlying intrinsic value of the target company, and the likelihood of that value being realized by current management or by a possible subsequent tender offer. It would also be proper to weigh the long-term value of the company against the value presented by the tender offer and the ability to invest the proceeds elsewhere. In making these determinations, the long-term business plan of the target company's management would be relevant.

Diversification

ERISA requires that plan fiduciaries diversify the investments of the plan so as to minimize the risk of-large losses, unless under the circumstances it is clearly prudent not to do so. Generally, a pension plan is not permitted to invest more than 10 percent of its assets in qualifying employer real property and qualifying employer securities.

Fiduciary standards for retirement plans maintained by State and local governments

The ERISA fiduciary standards do not apply to retirement plans maintained by State and local governments; accordingly, there are no generally applicable Federal standards for the investment of assets of such plans. No uniform fiduciary standards have been adopted by the States, although many States have adopted some variant of the ERISA prudence standard.

4. Securities and Exchange Commission (SEC) transaction fees

Under present law, securities market transactions on organized exchanges are assessed a fee of 1/300 of one percent of dollar volume. Merger and proxy filings are assessed a fee of 1/50 of one percent per transaction. Securities offerings are assessed a registration fee of 1/50 of one percent of the value of the offering.

5. Commodity Futures Trading Commission (CFTC) transaction fees

Under present law, there are no fees imposed on futures and options transactions regulated by the CFTC.

B. Prior Law

1. Prior law excise tax on issuance and transfer of securities

Between 1914 and 1965, excise taxes generally were imposed on the issuance and transfer of stocks and certificates of indebtedness issued by a corporation.[6] Immediately prior to their repeal, excise taxes were imposed at a rate of 0.1 percent of the actual value on the original issue of stock and 0.04 percent of the actual value on subsequent transfers of stock. In addition, excise taxes were imposed at a rate of 0.11 percent of the face value on the original issue of such certificates of indebtedness and 0.05 percent of the face value on the subsequent transfer of such certificates of indebtedness.

Certain exemptions were applicable to the imposition of these excise taxes. For example, obligations of the Federal Government, and State and local governments were exempt, as were certain shares of domestic building and loan associations and cooperative banks. In addition, transfers to or by a broker, transfers by reason of death or bankruptcy, and certain odd-lot sales were among the exempt transactions.

These excise taxes, which were administered through the sale of documentary stamps, were viewed as complicating the large variety of security transactions to which they applied. They were repealed as part of the Excise Tax Reduction Act of 1965 (P.L. 89-44).

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[6] These taxes were not imposed during the period between September 8, 1916, and December 1, 1917.

Continued

2. Prior law preference for long-term capital gains

Prior to the Tax Reform Act of 1986, gains on capital assets held for 6 months [7] or more received a partial exclusion from income. Gains on capital assets held for 6 months or less were taxed as ordinary income. This distinction created a relative penalty on income earned from short-term trades.

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[7] Since 1976, the holding period required to qualify for long-term capital gain or loss treatment has changed a number of times; it has been 6 months, 9 months, and 1 year.

II. DESCRIPTION OF PROPOSALS

1. S. 1654 (Senators Dole and Kassebaum)

The Excessive Churning and Speculation Act of 1989 (S. 1654) was introduced on September 21, 1989, by Senators Dole and Kassebaum. The bill would impose an excise tax on the short-term capital gains of certain pension funds. In particular, the bill would impose a 10-percent tax on gains from the sale of assets held for 30 days or less, and a 5-percent tax on gains from the sale of assets held for 30 days but not longer than 180 days.

The tax would not apply to gains from the sale of assets in a transaction which is entered into primarily to reduce risk of price changes of assets held by the pension plan, or to reduce risk of interest rate fluctuations with respect to borrowings of the plan. However, the transaction must be identified as a transaction exempt from the tax before the close of the day on which the transaction is entered into.

The tax would apply to sales of assets by qualified pension plans (sec. 401(a)), annuity plans (sec. 403(a)), and simplified employee pension plans (sec. 408(k)). The tax would not apply to plans with assets of less than $1 million.

The provisions would apply to assets acquired after the date of enactment of the bill.

2. S. 2160 (Senators Sanford, Sasser, and Ford)

The Long-Term Investment, Competitiveness, and Corporate Takeover Reform Act of 1990 (S. 2190) was introduced by Senators Sanford, Sasser, and Ford on February 22, 1990. Among other things, the bill would make it a prohibited transaction for a pension plan to sell or dispose of stock, securities, options, futures, or forward contracts which are held for less than 3 months unless less than 30 percent of such plan's gross income for the fiscal year is derived from such sales or dispositions. This rule is similar to the present-law rule applicable to RICs and REITs.

The bill also would amend the fiduciary rules of ERISA to provide that plan fiduciaries are required to take into account the long-term as well as the short-term interest of participants and beneficiaries of the plan in voting on a tender offer, merger, combination, or sale of substantially all the assets of a publicly owned business the securities of which are held by the plan.

In addition, the bill would amend ERISA to generally prohibit the use of excess assets following plan termination to finance the acquisition of employer securities.

3. Income tax surcharge on short-term trading income

As an alternative, the premise of S. 1654 could be broadened to impose an additional income tax at the rate of 5 percent on the net income from all short-term trades (as defined below). In addition to pension funds, the net income from short-term trades of all tax-exempt organizations, and all U.S. individual and corporate taxpayers would be subject to tax. The net income of all foreign persons earned from short-term trades of personal property located in the United States and of financial securities of U.S. entities, including partnership interests, options, futures contracts, and similar instruments also would be subject to tax when traded in the United States. A special 5-percent tax would apply to the net short-term gains of pass-through entities.

Any transaction involving an asset held for less than one year would be deemed a short-term transaction. Transactions covered would be all those for which domestic taxpayers are currently liable for capital gains inclusion. Taxpayers could be allowed to offset short-term gains with short-term losses. Alternatively, as in S. 1654, the tax could apply only to gain realizations with no offset for losses.

4. Securities transfer excise tax (STET)

A tax could be imposed at the rate of 0.5 percent of the value of the securities on the seller at the time of sale, exchange, or transfer of the security.[8] The tax would apply to all sales which take place in the United States and to sales abroad by U.S. citizens, residents, or tax-exempt organizations.

For administrative reasons, the tax would apply regardless of the period the seller held the securities. However, because the tax would be levied only once regardless of the length of the holding period, it would be much more significant for short-term than long-term holding periods.

The STET would apply to all equity securities and all public and private debt instruments which represent a long-term interest. The tax would apply to sales of options, futures contracts, and limited partnership interests. In addition, the tax would apply to sales of non-publicly traded securities.

For pass-through entities, such as mutual funds and limited partnerships, the tax would apply to both the trades made by the entity and trades of interests in the entity. The initial issue of any security would not be subject to the tax, but subsequent transfers would be subject to the tax. Consequently, origination of a mortgage or commercial loan would not be subject to tax, but subsequent transfers of the debt instruments would be subject to tax.

5. SEC transaction fees

Under the President's fiscal year 1991 budget proposal (submitted to the Congress on January 29, 1990), the fee on securities market transactions would be increased to 1/220 of one percent of the dollar volume traded. This fee would be extended to most over-the-counter securities transactions (*e.g.*, those transactions on the National Association of Securities Dealers Automatic Quotation

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[8] A STET was mentioned as a revenue raising option in 1987. *See* Joint Committee on Taxation, *Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means* (JCS-17-87), June 25, 1987.

A similar securities transactions tax is imposed in several other countries. (See the Appendix, Part A.)

(NASDAQ) system). The fee on merger and proxy filings would be increased to 1/40 of one percent of the value of the transaction. The registration fee on securities offerings would be increased to 1/40 of one percent of the value of the offering.

The proposed fee increases and fee impositions would be effective July 1, 1990.

6. CFTC transaction fee

Under the President's fiscal year 1991 budget proposal, a fee of 11 cents per transaction for CFTC-regulated futures and options trades would be imposed, beginning October 1, 1990.

III. ISSUES RELATING TO THE TAX TREATMENT OF SHORT-TERM TRADING

A. Background Data on Short-Term Trading

In general

The volume of securities trading has increased substantially over time. In the entire calendar year 1960, less than 800 million shares of stock were traded on the New York Stock Exchange. Recently, an average week had trades in excess of 800 million shares. Increased trading volume is not limited to the New York Stock Exchange. Volume also has grown substantially on the American Stock Exchange and in the over-the-counter markets. Moreover, financial innovations and reduced transactions costs have permitted the expansion of options and futures contracts. An organized market in stock futures generally did not exist 30 years ago. Today, the dollar value of stock futures contracts traded can exceed the dollar value of trades on the stock market. Foreign markets have experienced substantial growth in trading volume as well.

An apparent growth in short-term trading has accompanied the growth in volume of total trades. Many of the financial instruments introduced during the last two decades for trading on organized markets are short-term contracts. For example, options on a stock index or a commodity futures contract generally have expiration dates within two years of their purchase. Growth of markets in these new instruments accounts for a substantial portion of the growth in total volume of trades and volume of trades in which the investor holds the asset for less than two years.

Aside from growth in instruments which mature within a relatively short period, some observers point to evidence of turnover rates in the equity markets as evidence of shorter holding periods among investors in corporate equity. A turnover rate is the ratio of the market value of trades during a specified period (usually one year) to the average market value of all of the assets over the same period. Table 1 lists the turnover rate for issues listed on the New York Stock Exchange for selected years, 1920-1988.

Table 1.—Trading Activity on the New York Stock Exchange, Selected Years, 1920-1988

Year	Reported share volume (millions)	Dollar value of trading (billions)	Turnover percentage	Reported number of trades (thousands)	Average dollar size of trade
1920	227.6	n.a.	91	n.a.	n.a.
1930	810.6	n.a.	67	n.a.	n.a.
1940	207.6	n.a.	14	n.a.	n.a.
1950	524.8	n.a.	23	n.a.	n.a.
1960	766.7	n.a.	12	n.a.	n.a.
1962	962.2	n.a.	13	n.a.	204
1964	1,236.6	n.a.	14	n.a.	218
1966	1,899.5	98.6	18	n.a.	240
1968	2,931.6	145.0	24	9,704	302
1970	2,937.4	102.5	19	7,566	388
1972	4,138.2	158.6	23	9,339	443
1974	3,517.7	96.8	16	8,031	438
1976	5,360.1	165.7	23	9,587	559
1978	7,205.1	205.6	27	10,050	717
1980	11,352.3	382.4	36	13,015	872
1981	11,853.7	396.1	33	11,696	1,013
1982	16,458.0	495.1	42	12,609	1,305
1983	21,589.6	775.3	51	15,051	1,434
1984	23,071.0	773.4	49	12,954	1,781
1985	27,510.0	980.8	54	14,649	1,878
1986	35,680.0	1,388.8	64	18,972	1,881
1987	47,801.3	1,888.7	73	22,635	2,112
1988	40,849.5	1,365.9	55	17,739	2,303

n.a.—not available.

Source: New York Stock Exchange *Fact Book*, 1989.

Although in 1988 the turnover rate declined from its peak in 1987, it is higher than it was 20 years ago.

Some use a turnover rate as one measure of the average holding period of assets. For example, at a turnover rate of 20 percent, on average every asset on the exchange is sold once every 5 years. At a turnover rate of 60 percent, on average every asset on the exchange is sold once every 20 months. Under this measure, high turnover rates indicate short-term trading. However, this conclusion is not necessarily accurate. Some argue that the strong bull market of the 1980s induced many individuals to sell assets which they had held for a long period, and consume or reinvest the proceeds. Such sales and reinvestment would increase measured turnover rates, but need not indicate short holding periods. For example, if 80 percent of the shareholders of XYZ Company purchased their shares 10 years ago and the remaining 20 percent of shareholders purchased their shares within the last year, the turnover rate of XYZ Company shares would be 20 percent. If in the next year all shareholders sold their shares, the measured turnover rate for that year would be 100 percent. However, the average holding period of those shareholders who sold was 9 years.

Another factor that could affect measured turnover rates without reflecting shorter holding periods is the accounting methodology of measured turnover and the growth of options markets. Some observers note that institutional investors have made increasing use of options to hedge their portfolios against adverse price movements in the market. For example, institutions write and sell covered call options [9] against stock already in their portfolios. Proceeds from the option sale are treated as a sale for accounting purposes. If the price rises sufficiently to warrant exercise of the call option, the strike price times the number of shares also is accounted for as a sale. If the institution takes the proceeds from this sale and reinvests them, the transaction appears as a purchase. This is the case even if the proceeds are reinvested in the same stock which was called. Thus, in one sense, although the institution has engaged in three transactions, its holdings of the underlying asset have remained unchanged and its holding period also may be said to have been unchanged. But, in terms of turnover as generally measured, the institution has ended one holding period and started another one.

However, others argue that the same sequence of transactions might occur if the institution were attempting to arbitrage short-term price differences between the options and equity markets. They argue that exploitation of such short-term differences should properly be labeled short-term trades. On the other hand, the market may price different securities so that the number of such arbitrage opportunities is limited.

Pension funds, university endowments, and mutual funds

The importance of pension funds as participants in the securities markets has increased in the last 30 years. In 1960, pension funds held 4 percent of traded equity securities. In 1980, pension funds held 19 percent of traded equity securities. In 1987, pension funds held 24 percent of traded equity securities.[10] For comparison, in 1980, while private pensions owned 13.4 percent of the equities listed on the New York Stock Exchange, other institutional investors held 22 percent of the equities listed on the New York Stock Exchange.[11]

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[9] The buyer of a call option has the right to buy the underlying asset (*e.g.*, shares of stock) for a specified price (the "strike price") prior to a specified date (the "expiration date"). The seller of the call option must deliver the shares to the owner of the call option if the owner of the option decides to exercise the option. The call option is said to be "covered" if the seller owns a sufficient quantity of shares sufficient to "cover" the exercise of the option. Conversely, the buyer of a put option has the right to sell the underlying asset (shares) to the seller of the put option at a specified strike price prior to the option's expiration date.

[10] Arnold J. Hofman, "Pension Funds and the Economy, 1950-87," in U.S. Department of Labor, *Trends in Pensions*, 1989.

[11] Other institutions include insurance companies, investment companies, State and local pension funds, nonprofit institutions, common trust funds, mutual savings funds, and foreign institutions. *See* U.S. Department of Labor, *Trends in Pensions*, 1989, Table A-20.

Table 2 reports average turnover rates for the equity portions of portfolios of pension funds, college and university endowments, and mutual funds for selected years. Turnover rates have risen over the past two decades.

Table 2.—Mean Equity Portfolio Turnover, Selected Years, 1964–1986

[In percent]

Year	Pension plans[1]		College and university endowment funds[2]	Mutual fund[2]
	Unweighted[3]	Weighted[4]		
1964	9.3	n.a.	n.a.	n.a.
1966	12.5	n.a.	n.a.	n.a.
1968	19.9	n.a.	n.a.	n.a.
1970	25.8	n.a.	n.a.	n.a.
1972	31.4	n.a.	n.a.	48.7
1974	20.6	n.a.	16.5	38.7
1976	26.2	n.a.	16.1	39.5
1978	29.0	34.4	14.3	46.0
1980	49.6	39.5	21.7	47.1
1981	46.8	51.9	28.0	56.8
1982	63.2	56.4	28.0	75.1
1983	70.8	60.2	50.6	75.9
1984	n.a.	57.1	51.8	n.a.
1985	n.a.	63.2	n.a.	n.a.
1986	n.a.	61.3	n.a.	n.a.

[1] Source: U.S. Department of Labor, *Trends in Pensions*, 1989.

[2] Source: Stephen A. Berkowitz and Dennis E. Logue, "The Portfolio Turnover Explosion Explored," *The Journal of Portfolio Management*, Spring 1987.

[3] Average of stock turnover rates for all pension plans from SEI data.

[4] Dollar weighted average of stock turnover rates for all pension plans as reported on Form 5500.

n.a.—not available.

The turnover rates of pension funds and other institutional investors reported in Table 2 are comparable to the turnover rates on the New York Stock Exchange reported in Table 1. Consistent with this observation is data which show that pension fund share sales as a percentage of total share sales remained roughly constant at 20 percent between 1977 and 1986, reaching a high of 22 percent in 1981 and 1982 and a low of 16 percent in 1986.

Individuals

There is little data available which would permit analysts to compute turnover rates for individuals, because individuals are not required to report their portfolios. There is some information available, however, on the holding period of realized gains.

Table 3 reports, by holding period, the number of transactions and the dollar value of those transactions undertaken by U.S. individual taxpayers in 1985. The data show that approximately 60 percent of all individual realizations were of assets held 1 year or longer and more than 20 percent of transactions involved assets held 5 years or longer. If measured by dollar values, approximately 55 percent of all individual realizations were of assets held 1 year or longer and approximately 25 percent involved assets held 5 years or longer. When transactions are separated into gain and loss transactions, approximately 39 percent (12 percent if measured by value of gain) of gain transactions involved assets held less than 1 year, while 47 percent (35 percent if measured by value of loss) of loss transactions involved assets held less than 1 year.

Table 3.—Realization of Gains and Losses by Individuals by Holding Periods

[All asset types, 1985]

Holding period	Sales price [1]		Capital gain		Capital loss	
	Transactions (thousands)	Value (millions)	Transactions (thousand)	Value (millions)	Transactions (thousands)	Value (millions)
All transactions [2]	29,471	$402,136	19,454	$101,891	10,581	$22,124
Less than 1 year:						
Less than 1 month	4,150	81,599	2,555	3,018	1,684	2,269
1 to 2 months	1,361	17,395	850	1,019	594	783
2 to 3 months	968	12,855	580	1,008	454	709
3 to 4 months	851	11,214	465	721	407	509
4 to 5 months	705	7,818	401	555	367	555
5 to 6 months	618	8,464	367	558	274	367
6 to 7 months	829	9,883	576	1,427	260	508
7 to 8 months	486	6,269	308	891	190	497
8 to 9 months	593	6,324	403	669	189	440
9 to 10 months	528	5,640	372	641	181	438
10 to 11 months	434	4,215	290	679	142	253
11 to 12 months	650	7,182	380	876	236	377
Total, less than 1 year	**12,173**	**178,858**	**7,547**	**12,062**	**4,978**	**7,705**

1 year or more:						
1 to 2 years	4,916	52,343	3,031	9,187	1,961	3,915
2 to 3 years	3,329	33,395	2,040	7,728	1,322	2,502
3 to 5 years	3,043	38,401	2,206	13,411	873	2,773
5 to 10 years	3,256	46,054	2,364	21,073	910	3,727
10 or more years	2,753	53,084	2,268	38,430	537	1,500
Total, 1 year or more	**17,298**	**223,278**	**11,907**	**89,829**	**5,603**	**14,419**

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[1] Sales price column may include fewer transactions than the sum of the capital gain and capital loss columns because some taxpayers did not report the gross sales price of the transaction, only the net gain or loss.

[2] Data with missing holding periods omitted.

Source: Internal Revenue Service, Sale of Capital Assets File.

Table 4 reports, by holding period, the dollar value of transactions of capital gain realizations on corporate stock undertaken by individuals in 1973 and 1985. The dollar value of gain realized on holdings of less than 6 months, and on holdings of less than one year was a greater percentage of total realizations in 1985 than 1973. This difference could arise from differences in stock market performance in those years. 1985 was a strong year for the stock market, while in 1973 the stock market finished the year with a substantial decline in value over the last 3 months. Moreover, during the bull market of the 1980s many individuals bought stock. The figures in the table only report sales. Such short-term sales could be small relative to purchases of stocks which are added to individual portfolios and held for long periods. Table 4 reports that, even in a year like 1985, two-thirds of the dollar value of capital gains realized on corporate equity represented holdings which had been held 3 years or longer. Comparison of Table 4 to Table 3 reveals that measured by value of gain, approximately the same percentage of gains realized on corporate stock involved assets held less than 1 year as was the case for all assets. Of course, gains on corporate stock account for more than 50 percent of all gains.

Table 4.—Gross Gains on Corporate Stock Realizations by Individuals, by Holding Period (1973 and 1985)

Holding period	1973 gains[1]		1985 gains[2]	
	Gains (millions)	Percentage of total	Gains (millions)	Percentage of total
Total gains	$26,100	100.0	$56,120	100.0
Less than 6 months:				
Less than 1 month	164	0.6	1,717	3.1
1 to 2 months	115	0.4	793	1.4
2 to 3 months	107	0.4	663	1.2
3 to 4 months	76	0.3	546	1.0
4 to 5 months	68	0.3	444	0.8
5 to 6 months	45	0.2	396	0.7
Total gains held less than 6 months	573	2.2	4,559	8.1
6 to 12 months:				
6 to 7 months[3]	153	0.6	1,072	1.9
7 to 8 months	133	0.5	557	1.0
8 to 9 months	99	0.4	475	0.8
9 to 10 months	96	0.4	499	0.9
10 to 11 months	53	0.2	496	0.9
11 to 12 months	61	0.2	408	0.7
Total gains held less than 1 year	1,169	4.5	8,066	14.4
1 or more years:				
1 to 2 years[4]	n.a	n.a	6,050	10.8
2 to 3 years[4]	n.a	n.a	4,284	7.6
3 to 5 years[4]	n.a	n.a	6,118	10.9
5 to 10 years[4]	n.a	n.a	9,986	17.8
10 years or more[4]	n.a	n.a	21,617	38.5
Total gains held 1 year or more	24,931	95.5	48,054	85.6

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[1] Source: Steven Kaplan, "The Holding Period Distinction of the Capital Gains Tax," National Bureau of Economic Research Working Paper Number 762, September 1981.

[2] Source: Internal Revenue Service, Sale of Capital Assets file.

[3] In both 1973 and 1985 capital gains were long term if the asset was held 6 months or longer.

[4] Data from 1973 unavailable for holding periods greater than one year.

B. Policy Issues Relating to Short-Term Trading and Tax Policy Towards Short-Term Trading

Many observers have raised questions about the effects of short-term trading on the economy. As would be expected, one's beliefs regarding the effect of short-term trading on the economy help determine one's perception of the appropriate role of tax policy towards short-term trading. In general, observers have identified three broad areas on which short-term trading might affect the overall economy: the length of business and investor planning horizons; market volume, volatility, and liquidity; and the efficient allocation of the economy's resources.

1. Short-term trading and long-term investing

Some observers claim that many investors overemphasize short-term profits. Some argue that this is particularly true in the case of institutional investors such as tax-exempt organizations and pension funds.[12] This occurs because the money managers of these organizations frequently are judged on the basis of quarterly or monthly performance rather than performance over a longer period. This short-term focus of market participants exhibits itself in frequent short-term trading of securities. These observers contend that because of this emphasis on short-term trading, the stock market forces corporate managers to pursue short-term profits and often ignore investments with potentially large long-term profits. They note that long-term investments frequently may decrease short-term earnings and that the stock market penalizes decreased short-term earnings by limiting access to the capital markets for needed funds or by inducing a takeover and change in management. They also argue that short-term profits may come at the expense of funding research and development or that the research and development budget is redirected from seeking long-term breakthroughs to safer short-term projects. In these cases, a short-term focus will have long-term repercussions on the profitability of the firm.

Critics of this view dispute that the stock market has a short-term focus. They note that all shareholders want the value of their stock to be as high as possible, and this is true regardless of whether they have held their shares 1 month or 10 years. They argue that the desire for a high share value does not automatically instill a demand for short-term profits. They note that some evidence exists showing that institutional investors may favor stock in corporations which undertake high research and development expenditures, and the stock market appears to reward announcements of increases in research and development budgets.[13] They also cite the high values placed on certain technology stocks as evidence that the stock market is willing to pay for returns which accrue in the future.

Some critics also dispute the claim that institutional investors, in particular, have a short-term focus. They observe that financial obligations of many of the institutions often are in long-term liabilities, for example, pension fund liabilities. They contend that such future obligations should instill a desire to plan for the long term. Some evidence exists that pension funds with higher turnover rates perform less well than those with lower turnover rates.[14] This would provide further incentive to avoid excessive short-term trading. The critics also note that pension funds and other tax-exempt institutions have been major sources of funds for venture capital, which suggests that institutional investors do take a long-term view.

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[12] *See* Pat Choate and J.K. Linger, *The High-Flex Society* (New York: Knopf), 1986.

[13] *See* Gregg A. Jarrell, Ken Lehn, and Wagner Marr, "Institutional Ownership, Tender Offers, and Long-Term Investment," Office of the Chief Economist, Securities and Exchange Commission, April 19, 1985.

Some analysts contend that if American corporate managers have shortened their planning horizons, it is because of a high cost of capital. For example, a corporate manager may be looking at the choice between two alternative investments: one would return $1,000 for each of the next 10 years; and the other would return $2,500 for each of the next 3 years.[15] At an interest rate of 10 percent, the present value of the first alternative is $6,144.57, while the present value of the second alternative is $6,217.13. The profit-maximizing manager would choose the alternative which offered $2,500 for 3 years in lieu of the longer-run investment. However, if the interest rate were 8 percent, the present value of the first alternative would be $6,710.08 and the present value of the second alternative would be $6,442.74. The profit-maximizing manager would choose the alternative which pays $1,000 per year over 10 years and eschew the shorter-term alternative.

Some who believe that short-term trading has fostered a short-term planning horizon among American corporate managers advocate the imposition of a tax on short-term trading. They argue that such a tax will reduce the return to short-term trading. For example, a STET which assessed a tax of $1 per purchase over a one-year period would impose a $52 total tax liability on an investor who bought an asset each week only to sell it the subsequent week. The same tax would impose only a $1 total tax liability on an investor who bought an asset and held it throughout the year. If the two investing strategies were equally profitable in the absence of the tax, the long-term strategy would now be $51 better than the short-term strategy. Others argue that the return to short-term trading might be reduced more directly by imposition of an excise tax on short-term gains, such as would be imposed on pension funds by S. 1654.

Others note that a STET would increase the transactions costs of undertaking trades. They note that some evidence suggests that the primary cause of increased portfolio turnover rates is a substantial reduction in transactions costs over the past two decades.[16] Consequently, they argue that short-term trading can be effectively dampened by increasing transactions costs through imposition of a STET.

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[14] *See* Richard Ippolito and John A. Turner, "Turnover, Fees and Pension Plan Performance," *Financial Analysts Journal*, November-December 1987.

[15] The example assumes that, for the 3-year project, at the end of 3 years the proceeds only may be invested at the market interest rate.

[16] *See* Stephen A. Berkowitz and Dennis E. Logue, "The Portfolio Turnover Explosion Explored," *The Journal of Portfolio Management*, Spring 1987.

Opponents of taxes on short-term trading argue that such taxes are taxes on capital. Thus, they contend that as taxes on capital they will raise the cost of capital to American business. For example, one study suggests that a STET imposed at a rate of 0.5 percent would lead to a 9.3 reduction in the value of corporate equity.[17] It is cheaper for business to raise new equity capital when stock market values are high than when they are low. As the example above demonstrates, a higher cost of capital (the discount rate in the present value calculation) can lead corporate managers to choose investments which have shorter economic lifetimes. Consequently, opponents of income taxes on short-term gains and STETs argue that by increasing the cost of capital, such taxes are more likely to shorten corporate managers' planning horizons than to lengthen them.

2. Short-term trading, market volume, market liquidity, and volatility

Some economists believe that one of the basic services a stock market provides is liquidity, and liquidity depends upon volume of trades in the market. They note that the absence of a liquid market can appreciably increase the risk to the investor of undertaking a long-term investment and the cost of capital to business. An investor making a long-term investment is more likely to make the investment if a liquid market exists on which the investment can be sold should the need arise. In a liquid market, a buyer can readily be found and price changes are relatively small from transaction to transaction. The lack of a liquid market exposes the investor to greater financial risk as the investor might have to substantially discount his asking price in order to attract a buyer. Conversely, a business seeking to raise capital might have to increase its promised return if potential investors fear there is little possibility of subsequent sale of their holdings. Stock markets may provide liquidity by designating parties to "make a market" in given securities. These parties are responsible for ensuring that prices change in an orderly manner as supply reacts to demand. Some firms sometimes will provide liquidity for their own securities by promising to redeem shares at specified prices (e.g., oil and gas limited partnerships).

In this view, the growth of futures and options markets has increased opportunities for liquidity available to investors as well as provided new ways to spread risk. In this view, the short-term trader provides a useful service by increasing the market's liquidity. The increased liquidity and ability to spread risk should foster a positive environment for long-term investing and reduce the cost of capital to business. The increase in trading volume of the last two decades is viewed as a benefit to the economy under this view.

Others claim that too much liquidity can exist in a stock market. They argue that excessive liquidity encourages destabilizing speculation, which increases market volatility. Increased market volatility increases the riskiness of investment and thereby raises the cost of capital to business. They observe that the increases in market turnover and volatility have accompanied increases in volume. In particular, they point to the trading volumes and volatility in the months before and after the stock market crash of 1987. Critics of this view note that no theoretical connection between volume and volatility exists and the volatility prior to the 1987 crash was not notably high by historic standards. They observe that volatility always tends to rise in crashes and fall in booms.[18]

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[17] *See* Donald W. Kiefer, "A Stock Transfer Tax: Preliminary Economic Analysis," Congressional Research Service Report No. 87-278 S, March 31, 1987.

Some who believe that too much instability currently exists in the financial markets advocate tax policies such as a STET or an income tax on short-term gains to reduce market volume. By making shorter term trades less economical, such taxes should reduce trading volume. Critics of such policies argue that reductions in volume need not translate into reductions in volatility. They claim that such proposals likely will drive those who trade on small price movements from the market and leave in the market those who trade on large movements, thereby potentially increasing volatility. They note that market participants who trade on small price margins help ensure that price changes occur in an orderly manner. They also claim the loss of liquidity itself could produce larger price changes when large blocks of stock are sold. Proponents of such measures point to the foreign experience with security transfer taxes and observe that the Japanese and British markets do not appear to lack for liquidity.

3. Short-term trading and the efficient allocation of the economy's resources

Many economists believe it is important for markets to be "efficient." By efficiency, they mean that the prices of securities determined by the market are "correct" given all available information. Prices are correct or efficient if they incorporate all available information about the earnings prospects of the firms whose assets are traded as well as other information which might be relevant, for example, estimates of future inflation in the economy. Market efficiency is important because in market economies prices send signals about the relative value of goods and services. When consumers want more bread than currently is supplied, they bid up the price of bread. Similarly, if investors desire more investment in computer companies they drive up the prices of the stock of computer manufacturers. This makes it relatively inexpensive for existing manufacturers to raise new equity capital and also creates the opportunity for an entrepreneur to establish a new computer company and raise equity capital. In summary, some economists view the efficiency of financial markets as necessary to assure the efficient allocation of the economy's investment funds.

In the theory of efficient markets, the speculator and arbitrageur play positive roles. If a stock's price diverges from its underlying true or fundamental value, a profit opportunity exists.[19] If, for example, a stock's market price were less than its fundamental value, the speculator who recognizes this deviation will purchase shares. This increase in demand will drive the market towards the fundamental value. The speculator will continue to purchase shares until the market price equals the fundamental value. In the absence of speculation, the market price could provide investors with an incorrect signal, perhaps leading to a misallocation of investment resources. To the extent that the speculator's knowledge of the fundamental value resulted from information about the company that was privately possessed, by purchasing the stock and driving up its price, the information about the company's earnings prospects is revealed to other investors. A substantial body of evidence exists in the economics and finance literature which argues that the financial markets are efficient.[20]

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[18] *See* Merton H. Miller and Charles W. Upton, "Strategies for Capital Market Structure and Regulation," Report Prepared for the Center for Business and Policy Studies, Stockholm, Sweden, September 1989.

[19] In the theory of efficient markets, there is no "true" value of any good or service in a market economy. Prices simply reflect the value at which willing buyers and willing sellers contract for goods and services. In the case of marketable securities, current prices may reflect a weighted average of investors' expectations of future performance of the issuing firm.

Critics of the efficient markets view point to the crash of 1987 as inconsistent with an efficient capital market. More generally, they argue that evidence exists that stock prices are more volatile than is justified by changes in the underlying fundamental values of the assets.[21] In the view of such critics, such excess volatility may arise from excessive short-term speculation and financial arbitrage. Defenders of the efficient capital markets theory note that subsequent studies have questioned the statistical validity of the excess volatility view. They also argue that the so-called short-term portfolio insurance strategies which some blame for the crash of 1987 were generally only a United States phenomenon, and yet other markets fell significantly as well. They further assert that much of the crash could be explained by market fundamentals.[22]

Proponents of the efficient markets view state that any tax which either drives a wedge between market values and fundamental values, or which seeks to drive arbitrageurs and speculators from the market ultimately will harm the allocation of capital in the economy. They claim such taxes will slow the market's signalling function. They further note that a tax on the income from short-term trading will encourage investors to remain locked in to their investments. This creates capital market inefficiencies by discouraging investors form redeploying their funds to potentially more profitable investments. Proponents of such taxes question both the efficiency of the market and the degree of harm which would befall an efficient market if a modest income tax surcharge on short-term gains or a STET were imposed. They note that a modest STET would raise total transactions costs to approximately the level that prevailed prior to the deregulation of brokerage commissions in 1974. They observe that many of the studies providing evidence for the efficient markets theory draw on data from prior to 1974 and therefore a return to higher transactions costs could not be too harmful. Critics of such taxes note that gains in efficiency have come about from the expansion of the options and futures markets and that these efficiency gains are threatened by any policy designed to reduce use of or access to these markets.

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[20] *See* Eugene Fama, "Efficient Capital Markets: A Review of the Theory and Empirical Work," *Journal of Finance*, vol. 25, May 1970.

[21] *See* Robert Shiller, "Do Stock Prices Move Too Much to be Justified by Subsequent Changes in Dividends?", *American Economic Review*, June 1981.

[22] *See*, Miller and Upton, "Strategies for Capital Market Structure and Regulation." Some have cited tax legislation reported out of the House Ways and Means Committee as responsible for a sizeable portion of the 1987 crash. *See* Mark Mitchell and Jeffrey Netter, "Triggering the 1987 Stock Market Crash: Anti-Takeover Provisions in the Proposed House Ways and Means Tax Bill," *Journal of Financial Economics*, September 1989.

Some analysts have asserted that even if the financial markets are efficient at determining prices, there is another efficiency loss about which policy makers should be concerned. They argue that too much human capital is devoted to trading paper assets rather than to creating new wealth in the economy.[23] They observe that while the level of employment in the securities industry has increased over the past two decades, trading volumes have increased even more dramatically. They argue that little of the work is involved in directing new real investment, but rather that tremendous resources are devoted to a zero-sum game where what trader A gains is offset by a loss to trader B. Because this activity consumes substantial resources, these analysts conclude that the private benefits which accrue to the individuals far exceed any benefits to society as a whole. Another way to express this view is to say that from society's perspective there is too much investment in producing information of the type needed to make profitable trades, and that the extra information has insufficient value for society to justify its cost of acquisition. In this view, tax policy which reduces the private returns to trading would reduce the amount of human resources devoted to gathering this extra information, and permit the resources to be redeployed to society's benefit.

Critics of this view respond that one should not judge the securities industry solely by what those relatively few highly compensated individuals do for society, but rather by what the industry does for society. They argue that the highly compensated trader helps support the infrastructure of the securities industry which provides liquidity and price discovery services to all. They note that tax policies designed to contract the number of short-term trades would have the collateral effect of reducing liquidity and the efficiency of price discovery services to all.

4. Other issues related to taxation of short-term trading

Hedging.—Critics of taxes on short-term trading point out that legitimate hedges constitute a substantial number of short-term trades. They argue that taxes which discourage hedging could penalize risk-taking by reducing the investor's potential for spreading risk. Proponents of taxes on short-term trades counter that exceptions could be provided for legitimate hedges. However, such exceptions could be difficult to administer.

Off-shore trading.—Some critics of taxes on short-term trades have argued that such taxes will create incentives to trade outside the United States. They argue that this will harm the domestic securities industry. Proponents of such taxes counter that the British and Japanese markets have grown despite security transfer taxes. They note that America is geographically positioned to provide a trading market which is critical to the growth of the 24-hour trading day, and that this should help demand for trading to remain strong. Critics of taxes on short-term trading claim that the British and Japanese reduction in their security transfer tax rates was the result of competition with America's trading markets. They also claim that the Swedish transactions tax makes futures markets uneconomic in Sweden.[24]

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[23] *See* Lawrence H. Summers and Victoria P. Summers, "When Financial Markets Work Too Well: A Cautious Case for a Securities Transactions Tax," Annenburg Conference on Technology and Financial Markets, February 28, 1989.

Progressivity.—Generally, higher-income taxpayers own the majority of financial securities which are held by individuals in the United States. Consequently, some proponents have claimed that any tax on short-term trading will be generally progressive, with the tax falling more heavily on higher-income taxpayers than lower-income taxpayers. Others caution that the case for the progressivity is not certain. They note that with the substantial ownership of corporate equity by pension funds that such taxes may, in fact, fall on the retirement incomes of millions of taxpayers.

C. Issues Relating to the Design of Taxes on Short-Term Trading

1. Breadth of transactions subject to tax

In general.—Determining the appropriate breadth of the tax is difficult. If the tax does not apply broadly to all types of transactions, certain transactions would be favored over other transactions, creating capital market inefficiencies. Similarly, if the tax does not apply broadly to all traders, trades by some individuals would be favored over trades by other individuals. Such a distinction would place some traders at a competitive disadvantage.

Breadth of assets subject to tax.—A neutral tax should apply to debt as well as equity. To do otherwise would distort financial choices in favor of debt. However, if the goal of the tax is to induce managers to plan with a longer time horizon, including debt may be unnecessary because managers are likely to concentrate more on the price of their company's stock than on the price of their company's debt. Inclusion of governmental securities raises the cost of borrowing to Federal, State and local governments. Exempting government debt would give investors an incentive to purchase government securities rather than invest in private enterprises. Excluding short-term debt instruments favors short-term borrowing. However, including short-term borrowing under a uniform tax rate increases short-term borrowing costs relative to long-term borrowing costs.

For example, even if interest rates remained unchanged, it would cost more for a business to issue a six-month note in January and a subsequent six-month note in July, than to issue a single one-year note in January. In the absence of the tax, with a rising term structure of interest rates, the business might prefer to continuously roll over short-term notes because this permits the exploitation of lower short-term interest rates and provides added flexibility since they always have the option of locking in long-term interest rates.

For a STET, particular design issues arise. Including debt could create the administrative problem of determining when debt is a security, for example, whether commercial loans would be subject to the tax. Not including debt could exacerbate the administrative problem of determining which securities are debt and which are equity. To be neutral, a STET should apply to publicly and non-publicly traded securities. Inclusion of non-publicly traded assets would make administration of the tax difficult. Not including non-publicly traded securities would create a bias in favor of raising capital outside of the public markets, and thereby subject the process to less regulatory oversight.

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[24] *See* Miller and Upton, "Strategies for Capital Market Structure and Regulation," and "Government to Axe Turnover Tax," *Tax Notes*, vol. 46, February 12, 1990, p. 809.

Under the income tax surcharge option, using the existing tax base of sales of capital assets could make exceptions difficult to design and create administrative complexity. If, for example, sales of real property were to be exempted, would losses on real property be able to offset gains on the short-term trades of equities? Such exceptions would necessitate the design of an entirely new tax, rather than the imposition of a simple surcharge.

Breadth of individuals subject to tax.—To be neutral, any tax on short-term trading should apply to all traders, including otherwise tax-exempt institutions and foreign persons. Some have observed that to exclude foreign persons would create a competitive advantage for foreign traders in the United States. For example, they have argued that exclusion of trades by foreign persons would make it less expensive for a foreign person to take over a United States business than it would be for a domestic acquiror. Others have countered that under an income-based option, taxing the trades of foreign persons might require overriding outstanding tax treaties. Imposition of a STET would not require overriding tax treaties.

2. Transactions undertaken abroad

In transactions undertaken overseas, the ability to use "street names" could make administration and compliance more difficult. Transactions made by U.S. citizens abroad present significant reporting problems. It may prove difficult to exert jurisdiction over foreign situs transfers. Exempting such transactions would provide an incentive for U.S. citizens to trade abroad. Transactions by U.S.-owned foreign intermediaries could present significant avoidance possibilities. Broadening the base of the tax to include such intermediaries may curtail modifying existing tax treaties.

As an example of the difficulties of dealing with transactions undertaken abroad, the U.K. attempts to subject foreign trades to its STET by imposing the STET at triple the regular rate on shares sold for trading on foreign markets. This affects only new issues and not the stocks of outstanding securities which could trade abroad. However, avoidance of the U.K. STET through the trading of other securities in U.S. markets could prove to be a problem for U.K. tax authorities.

3. Pass-through entities

Under either the STET or income tax surcharge option, consideration must be given to the treatment of pass-through entities (e.g., mutual funds and partnerships). Taxing both the trades made by the entity as well as trades in the interests in the entity would subject such investments to a double tax. On the other hand, taxation at only one level would create avoidance problems. For example, if the tax only applied to trades involving interests in the entity, it would be possible for investors to create mutual funds which engaged in short-term trades at no penalty. The double tax could be reduced by applying one level of the tax at a reduced rate.

APPENDIX:

FOREIGN COUNTRIES' TAXES AFFECTING SHORT-TERM TRADING

A. Securities Transfer Excise Taxes

Overview

Seven of the ten member nations of the European Economic Community currently impose some form of securities transfer excise tax. Each of the United States' four major trading partners in the Pacific rim imposes a securities transfer excise tax. Canada does not impose a securities transfer excise tax. Below are brief summaries of the securities transfer excise taxes which are imposed in Europe and the Pacific rim.[25] Table 5 provides summary information on revenue raised by such taxes in several of the countries.

Countries in the European Economic Community

Belgium.—Belgium imposes a securities transfer excise tax (STET) on the exchange of shares, bonds, and other securities. The basis of the assessment is the transfer price rounded to the nearest BFR 100. The tax rates are as follows: debt securities issued by the national government—0.07 percent, debt securities issued by foreign governments—0.14 percent, other securities/shares—0.35 percent, and futures contracts—0.17 percent.

In addition to the tax on transfers, Belgium has an annual tax on securities quoted on the Belgium stock exchange. The tax rate is 0.42 percent and is payable by the company whose stock is listed on the exchange.

Denmark.—Denmark imposes a STET of 0.5 percent on the transfer of securities. The tax is customarily shared equally between the buyer and the seller. Trades between professional brokers are exempt from the tax. The STET in Denmark takes the form of a stamp duty.

France.—France assesses a STET on the transfer of securities, bonds, and commodity contracts. The tax rate on the transfer of securities and bonds is 0.3 percent for transactions less than FF 1,000,000 and 0.015 percent for amounts in excess of this amount. The tax rate on the transfer of commodity contracts varies from 0.2 to 0.26 percent.

In general, transactions between professional brokers trading in their own accounts are exempt from the tax. In addition, most transactions carried out on provincial stock exchanges are also exempt from the STET.

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[25] *See* Gregg A. Esenwein, Congressional Research Service Memorandum, May 10, 1989, and My Saw Shin, "Taxation of Stock Transfers in Various Foreign Countries," Law Library of Congress, July 1989.

West Germany.—West Germany has two distinct taxes on capital transactions. The first is called a "company tax" and is assessed when a company first issues stock. It is also imposed when there are other increases or additional contributions to a company's capital. In these instances, the tax rate is 1 percent. In the case of stock which is issued as a result of mergers, the tax rate is 0.5 percent.

The second type of capital transfer tax is assessed on stock exchange transactions. The tax rate ranges from 0.1 to 0.25 percent, with the lower rate applicable to the transfer of government securities. The tax is imposed on all domestic transactions and on transactions that take place abroad if one of the parties is a West German national. The tax rate is halved if the exchange occurs abroad and only one of the parties engaged is a West German national.

Italy.—Italy imposes a STET on the exchange of stocks, bonds, and various other securities. The rate of tax depends on the type of transaction and the nationality of those involved in the exchange. The tax rate is halved in the case of transfers of Italian government securities or securities backed by the Italian government.

Netherlands.—The Netherlands imposes a STET on the purchases and sales of securities by resident stockbrokers. The tax rate is 0.12 percent. In addition, the Netherlands also assesses a capital tax of 1 percent on new issues of share capital. The tax is paid by the corporate entity issuing the shares. The Netherlands has proposed abolishing its stock transfer tax effective July 1, 1990.[26]

United Kingdom.—The United Kingdom (U.K.) imposes a STET in the form of a stamp duty. The tax rate is 0.5 percent on the exchange of stock or other marketable securities.[27] The 0.5 percent tax rate is also assessed on other increases or contributions to a corporation's capital, shares issued as a result of mergers, and corporate repurchases of outstanding shares.

The rate of tax is tripled for securities that are sold for trading on foreign markets. For instance, the U.K. imposes a tax of 1.5 percent on the exchange of American Deposit Receipts, or ADRs. ADRs are securities that are traded on U.S. stock exchanges but represent shares in U.K. and other non-U.S. firms. The tax on ADRs was adopted as a means of reducing the movement of capital transactions from London to U.S. stock exchanges.

Pacific Rim Nations

Hong Kong.—Hong Kong imposes a STET of 0.6 percent on the transfer of stocks, bonds and other securities. The tax is split evenly at 0.3 percent between the buyer and seller of the securities. The tax is in the form of a stamp duty.

Japan.—Japan imposes a STET on the transfer of stocks, bonds, and other securities. Japan lowered its tax rates in 1989. Tax rates range from 0.01 to 0.30 percent,[28] depending on the type of instrument being exchanged and the parties engaged in the transaction. In general, transfers conducted by professional securities firms are subject to a lower rate of tax.

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[26] *See* "Another Turnover Tax May Be Decapitated," *Tax Notes*, vol. 46, February 12, 1990, p. 808.

[27] The tax rate was reduced from 2 to 1 percent in 1984 and from 1 to 0.5 percent in 1986.

[28] Prior to 1989 tax rates ranged from .01 to 0.55 percent.

For example, if handled by a securities firm, the sale of stock is subject to a tax of 0.12 percent; exchanges of stock by other entities are taxed at a rate of 0.30 percent. Lower rates apply to sales of corporate debt, with rates of 0.06 and 0.16 percent. Sales of national bonds conducted by a securities trading firm are subject to a tax of 0.01 percent, while any other sales of national bonds are subject to a tax of 0.03 percent.

Japan has proposed a transfer tax on exchanges of financial futures, a new capital market which opened in June 1989. The tax will take effect on October 1, 1990. The tax rates for this particular capital transfer tax will be 0.0001 percent (one ten thousandth of one percent) of the value of the transaction. However, for the first two years, the tax rate will be at one-tenth the regular rate in the case of Euroyen deposit rate futures and no tax will be imposed on Eurodollar deposit rate futures or yen-dollar exchange rate futures contracts.

Republic of Korea (South Korea).—South Korea levies a STET of 0.5 percent on the transfer of stocks, bonds and other securities. No tax is assessed if both parties to the transfer are nonresidents.

Taiwan.—A STET of from 0.15 to 0.3 percent is assessed on the value of stocks, bonds, and other securities at the time of transfer. Government securities are exempt from this transfer tax.

Table 5.—Security Transfer Taxes and Tax Revenue in Selected Foreign Countries in 1985

Country	Revenue (billions) [1]	Tax revenue as a percentage of		
		Total revenue	GNP	Market value of equity
France	$0.6	0.26	0.12	1.19
Germany	0.3	0.14	0.04	0.28
Italy	1.6	1.10	0.38	6.10
Japan	2.3	1.42	0.17	0.34
Netherlands	0.4	0.63	0.32	1.17
United Kingdom	1.4	0.80	0.30	0.01

[1] Revenue in dollars calculated at average exchange rate for 1985.

Source: Lawrence H. Summers and Victoria P. Summers, "When Financial Markets Work Too Well: A Cautious Case for a Securities Transactions Tax," Annenburg Conference on Technology and Financial Markets, February 28, 1989.

B. Taxes on Income from Short-Term Trades by Individuals

Overview.—A number of countries do not tax the income from capital gains regardless of the period for which the asset was held. Some countries which do tax the income from capital gains do not distinguish holding period. For example, Canada, which provides a partial exclusion for income from capital gain, does not vary the exclusion by holding period. Some countries (*e.g.*, the United Kingdom) adjust the measure of gain for inflation (indexing). Adjustments for inflation vary by holding period. Below are brief descriptions of some foreign countries' tax distinctions for gains based on holding period.[29]

Belgium.—Capital gains resulting from the sale of commercial or industrial assets are generally taxed as part of income with no distinction for holding period. Gains on other assets generally are exempt from tax. The only holding period distinction arises on capital gains on land located in Belgium which has been held by individuals for less than eight years.

France.—Gains realized by businesses or individuals on real property held two years or less and on personal property held one year or less are treated as ordinary income. Long-term gains on such property receive a preferential tax rate. Holding period distinctions do not apply to securities.

Germany.—Gains realized by businesses are included in ordinary income. For individuals, gains are distinguished by short-term and long-term with short-term gains in excess of DM 1,000 (approximately $588 at current exchange rates) are included in ordinary income. Long-term gains are exempt. Gains from real property held for less than two years and personal property (including securities) held for less than 6 months are considered short-term.

Japan.—On sales of securities, no distinction is made for holding period. Gains on sales of real estate are separated into short-term (held less than 10 years) and long-term (held 10 years or more), with higher tax rates applying to short-term gains. On other assets, gains realized on assets held less than 5 years are taxed as ordinary income, while only one half of the gain on an asset held 5 years or longer is included in ordinary income.

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[29] *See* Organization for Economic Co-operation and Development, *Taxation of Net Wealth, Capital Transfers and Capital Gains of Individuals* (Paris: OECD), 1988.

PREPARED STATEMENT OF NICHOLAS F. BRADY

Mr. Chairman and Members of the Committee: I appreciate the opportunity to meet with you today to discuss the effects of short-term investment behavior on the ability of American companies to compete in world markets. This is a subject I have spoken about a great deal. In order to achieve the Administration's goal of enhancing economic growth by improving our nation's ability to compete in an integrated world economy, we must adopt longer time horizons in both the corporate and investment community.

Short-term investing is neither all good nor all bad. Some trading activities are necessary to provide liquidity and efficiency to the marketplace. The existence of a highly liquid market which efficiently reflects underlying economic values is important to providing low-cost capital to American businesses. And the cost of capital influences the investment horizons of corporate managers.

COST OF CAPITAL

For projects which have long-term payoffs, the cumulative effect of a high funding cost, or cost of capital, can be devastating. Thus, as we review policies with an eye towards competitiveness, we must not lose sight of the importance of capital costs on investment horizons.

The Bush Administration is committed to lowering America's cost of capital. With this mind, the President transmitted to Congress the Savings and Economic Growth Act (SEGA) which, as you know, has been introduced by Senators Packwood, Dole and Roth as S. 2071. The Family Savings Plan is designed to expand the pool of personal savings, which directly influences the supply of capital available for America's corporations. The SEGA legislation also reinstates a preferential tax rate for capital invested by long-term investors. Our capital gains proposal is designed specifically to encourage all investors to adopt a more permanent approach toward stock ownership, which is the subject of this hearing today.

We do not believe these measures alone will resolve the disparity in capital costs faced by American businesses as compared with some foreign competitors. Studies on this subject conclude the gap is considerable. None of our major trading partners fully taxes corporate income at both the corporate and personal levels. The Treasury Department is engaged in an extensive study of ways in which the personal and corporate tax systems could be integrated to prevent the double taxation of dividends. This too is an important element in lowering the cost of capital which is so important to the economics of long-term investing.

CORPORATE GOVERNANCE

Long-term investing is more than just pure economics. A second critical element in the competitiveness equation is the relationship which exists between the providers of capital (investors) and the users of capital (corporate managers)

Short-term stockholders are usually unwilling to stay the course and participate as owners. One short-term investor replacing another short-term investor is not likely to provide effective accountability or encourage long-term management decisions. At the same time, corporate executives who are worried about their shareholders' commitment to the company's long-term strategies are more likely to focus on producing short-term results in an attempt to bolster their stock price.

We need to examine the current relationship between corporate executives and investors. If executives felt their shareholders were committed to maximizing the long-run value of the company, perhaps they would be bolder in pursuing aggressive strategies with the more strategic payoffs which are required to compete in world markets. Over time, these strategies could create greater shareholder wealth; but to the extent that investors feel that the system is unresponsive and insensitive to their interests, they may be unwilling to make a long-term commitment.

We need to create an environment with more investors who understand a company's long-term strategies and who back the company as it strives to prove the merits of those strategies. Together, investors and executives need to operate within a system of corporate governance that can effect management change consistent with long-term objectives.

Our country's pension funds, which contain retirement savings for 75 million Americans, are the ideal candidates to provide the committed capital our corporations need. They also have the broad knowledge to understand the development of long-term corporate strategies. This does not mean that outside shareholders should run the daily affairs of companies; but as shareholders they are an essential element in a system of governance that provides them a voice in setting goals which would lead to policies to enhance the long-term value of their investment.

I believe we should encourage executives and shareholders, together with the state and Federal governments, to review the present corporate governance process in order to provide an environment more conducive to dialogue and partnership.

If we can create an atmosphere which harmonizes the interests of managers and shareholders, I believe it will lead to a more responsible and less destructive way of converting shareholder/owner views into long-term plans. Then, less attention will be paid to policies aimed at short-term profits by corporate managers whose primary goal is avoiding a takeover.

SHORT-TERM TRADING LEGISLATION

Now let me turn to S. 1654. As I have indicated, I believe that steps are needed to lengthen the time horizons of investors and corporate executives. However, I am concerned that we have not thought long enough to be sure S. 1654 is the answer.

S. 1654 takes the approach that a tax should be placed on gains which are realized by pension funds on the sale of stocks held less than six months. Perhaps we should apply the ERISA rules to make clear that the fiduciary duty to maximize return for fund beneficiaries is best achieved by long-term investing, not short-term trading. Last Spring, the Treasury and Labor Departments took a step in this direction by pointing out that fiduciaries do not have to accept any tender offer if they believe the long-run value of the stock is higher.

Although the economic impact of speculation and arbitrage is not fully understood, it is clear that an excessive amount of these activities has never produced lasting values. Yet today in the U.S. there is a substantial amount of capital, not just money but some of the brightest minds in the country, committed to playing short-term trading games. Efforts to reduce excessive speculation in our markets would permit more of our human and economic resources to be committed to allocating capital to the companies which provide jobs, produce products and preserve our nation's standard of living. Defenders of all the turnover in our markets cite liquidity as the benefit of this practice. Liquidity is not the ultimate purpose of the market; an effective and efficient allocation of resources is.

I served as chairman of the Presidential Task Force on Market Mechanisms established to explore the causes of the October 1987 market break. One of the conclusions the Task Force reached is that reducing speculative trading would raise investor confidence in the markets. Others would point out that by most measures, overall volatility in the U.S. equity markets has not increased substantially over the past 15–20 years—even though trading activities have grown manyfold. This may be true, but there have been a few days which really shook the market and threatened the stability of the payments and settlement system, most notably in October of 1987 and 1989. The Task Force report suggests that excessive speculation increased the speed and violence of these declines. These sudden, precipitous drops have shaken the confidence in our markets, which is just as important as what has happened to turnover rates or measured volatility.

I believe attempts to encourage longer investment horizons do send positive signals to investors. This hearing itself is important as it raises the critical issue of pension fund goals and objectives. While the Treasury Department does not now support S. 1654, we applaud its objectives of promoting long-term investment.

We would be interested in working with the Committee to come up with a considered approach which would balance the goals of liquidity, providing committed capital and providing a secure source of retirement income. We do have the worry that agreeing to a tax on pension funds might lead to taxes on individuals and other entities to which we would be opposed.

We are only suggesting that pension and other tax-exempt funds be placed in a special category in this country. They have been granted freedom from taxation; why shouldn't they be this country's reservoir of long-term capital? Pension funds have long-term obligations; short-term speculation should have no place under this view. But, taxation should be viewed as a last resort in establishing this goal.

Enforcement of S. 1654 could prove difficult. This legislation leaves many questions unanswered such as to how to prevent the investors targeted by this tax from achieving the same economic effect by using the options market and other mechanisms without technically triggering the tax. This bill provides an exemption for hedging transactions. While the use of futures in hedging activities is certainly a legitimate business activity, the bill provides little definition of what kinds of activity are intended to be excepted by the hedging exception. Resolving these definitional issues could prove difficult.

As I said, not all short term trading is bad. There is a legitimate need for market makers who buy and sell securities, and attempt to secure a narrow spread. These investors reduce the overall cost of transactions and provide liquidity, which are characteristics needed for efficient markets. However, in my opinion, it is questionable whether our nation's pension funds ought to be the ones to fulfill this particular role in the markets.

In conclusion, I concur with the goal of the sponsors of this legislation. I believe longer investment horizons are critical to our nation's future world position. But I again recommend to you the Savings and Economic Growth Act of 1990, S. 2071. My strong conclusion is that, should we take action to affect the role of pension funds, it should be done within the framework of the SEGA legislation. After all it is the same subject.

Prepared Statement of Senator Bob Dole

Mr. Chairman, I want to thank you for holding this hearing on the problem of declining long-term investment in American business.

The short-term investment practices prevailing in our capital markets are hurting American business, American investors, including pension fund beneficiaries, and the American economy. The emphasis on short-term investment performance forces corporate managers to maximize profits in the current quarter, often at the expense of research projects or product development which would enhance future productivity. We cannot afford to continue mortgaging our economic future in this fashion.

Over the last 30 years, turnover rates on the New York stock exchange have more than quadrupled while the percentage of traded shares held by pension funds has increased more than six fold. And, significantly, the percentage of *traded* shares held by these funds exceeds their overall ownership of stock. In addition, there have been troubling reports of the participation of some pension funds in program trading or takeover speculation in complete disregard of their market impact.

Certainly, pension funds are not solely responsible for the excessive turnover and volatility in our equity markets. The presence of other institutional investors in our stock market has also increased, and these institutions may trade as frequently, or more frequently, than pension funds. However, pension funds have a unique fiduciary responsibility. It is appropriate to ask them to consider the long-term well being of their beneficiaries in the broadest sense, taking into account their job security and the long-term viability of the businesses they serve.

Moreover, short-term investing may not be even in the short-term best interests of pension fund beneficiaries. Labor department statistics show that pension funds with high turnover rates perform less well on average than funds with lower turnover rates. And the New York times reports that fewer than 30% of the top-rated money managers out-performed the market in 1989. Thus, pension funds would have profited more *in 1989 alone* from a buy-and-hold strategy than they did from investing with 70% of the most prominent market specialists!

It has been alleged that any short-term trading tax will impair the perfect liquidity of the stock market, resulting in inefficiencies which discourage investment. These same critics, however, do not complain about efforts to reduce capital gains tax rates for long-term investment although the president's proposal, to take one example, would tax three-year investments at a top rate of only 19.6%, more that 13% less than the current maximum. If a potential 13% penalty for sales within one year by taxable investors is welcomed, it is hard to complain about a 5% penalty for sales within only the first six months.

In addition, until recently, few investors would complain about the performance of the Japanese stock market. However, because of a pattern of interlocking corporate ownership, approximately 70% of Japanese shares are permanently off the market. Thus, Japanese business has been able to combine a supply of very "patient" equity capital with a booming market for investors.

S. 1654, which I have co-sponsored, is intended to modify the investment behavior of pension funds. No fund needs to pay tax under this bill. In fact, congressional estimators believe that, if this legislation is enacted, most funds will adjust their investment behavior to avoid tax.

Moreover, S. 1654 does not prohibit short-term investing by pension funds. It merely charges (at most) 10% of the profits, less than the lowest individual income tax rate. In addition, the legislation allows funds to hedge freely any element of their long-term portfolio: market risk, interest rate risk, currency risk. Thus, no fund will be forced to sustain losses by this legislation.

Mr. Chairman, if American businesses become less and less competitive because they cannot plan for the long term, American workers will lose not only their retirement savings, but also their relative standard of living, and even their livelihood. I hope that we can supply an incentive for more patient investing by our pension funds. If we succeed, these funds will pay no tax, but every American worker and investor will be better off.

PREPARED STATEMENT OF SENATOR NANCY LANDON KASSEBAUM

Mr. Chairman, I am quite pleased the Senate Finance Committee has decided to hold hearings on the need to provide an incentive for institutional investors to make long-term investments.

The legislation Senator Dole and I have introduced provides a tax incentive for pension funds to make long-term investments. This incentive is similar to the sliding-scale, capital gains proposal. Under both bills investors have a tax incentive for making long-term investments.

In fact, the Dole-Kassebaum bill complements the capital gains proposal Whereas the capital gains proposal encourages long-term investment by individual investors, our bill encourages long-term investment by institutional investors—specifically pension funds. Without something like the Dole-Kassebaum proposal, these tax-exempt investors have no such tax incentive.

If we are really serious about long-term investment, we should provide incentives not only for individual investors but for institutional investors as well. Moreover, if we are really serious about fiscal restraint, we need to provide incentives for long-term investment that do not lose revenue. The Dole-Kassebaum bill accomplishes both objectives.

I should point out, this bill does not raise a lot of revenue. As, you know, long-term investments are not subject to the legislation. The Joint Committee on Taxation estimates that pension fund managers would avoid the excise fee by simply engaging in long-term investment strategies. This is the singular purpose of the bill. This summer, several Wall Street executives testified that such a change in investment strategies is not only desirable to stabilize our capital market, but necessary for our country to maintain its international competitiveness.

They suggested that we consider tax incentives to encourage long-term investment by pension funds and institutional investors. Specifically they suggested a sliding-scale capital gains tax on pension funds. The Dole-Kassebaum bill follows their suggestions. It encourages long-term institutional investment and does not lose revenue.

I agree with Secretary of Treasury Nicholas Brady that short-term behavior by pension funds hurts our capital markets. I would also agree with the Wall Street experts that short-term behavior not only hurts our capital markets but hurts our industrial productivity as well.

PREPARED STATEMENT OF MICHAEL A. MCGRATH

Good afternoon. My name is Michael A. McGrath and I am the state treasurer of Minnesota. I am appearing today on behalf of the National Association of State Treasures (NAST) and the Council of Institutional Investors.

NAST represents State Treasurers in all 50 States, the District of Columbia, the Commonwealth of Puerto Rico and 4 Territories. The Council of Institutional Investors includes over 50 member groups representing city, state, police and fire and union pension funds.

State treasurers invest in pension assets worth $600 billion and the council represents $300 billion in invested pension assets.

Being a member of the last panel on a long day, I know my remarks must be short—but not short-term—so I will limit myself to a few brief points.

As State Treasurer, I serve as one of 5 elected officials, including our Governor, as a member of the Minnesota State Board of Investment. I also serve as the Governor's appointee on the Minnesota State Retirement System Board of Directors. The retirement system in Minnesota administers eight statewide retirement programs, serving approximately 200,000 public employees—teachers, state employees, local government employees, police and fire, highway patrol and judges. The value of our combined assets is $15.5 billion as of the end of December, 1989.

The groups and individuals I represent are very concerned about the proposal to tax the short term capital gains of our funds. I want to be very clear that we share, in general, your concerns about improving the long term investment horizons as viewed by managers of our nations financial assets. However, we believe that proposals such as these, while well intentioned, are a simplistic solution to a complex problem. In short, we do not believe the proposals in the bill will do much to achieve their desired policy goal of improving our international competitiveness.

What they will do is to exacerbate an existing problem of underfunded public pension funds. For example, the Minnesota state retirement system, based on a actuarial assumptions, is presently funded to meet 72% of our commitments, or in other words is 28%. The imposition of taxes such as are envisioned under this proposal, our long range target for fully funding our Minnesota plans is the year 2020.

Proposals to tax the short term gains of public pension funds would shift even more responsibility for meeting this commitment to our employees and retirees on to our already overburdened state and local taxpayers. Funding the shortfall imposed by the proposed capital gains taxes would force state governments to either raise additional taxes, increase the contribution paid by active employees, or reduce the benefits paid to retirees.

For many state public pension funds the imposition of a tax on short term capital gains would have an especially cruel result. A major investment option in many funds is a fund based on a passive index tied to the Standard and Poors 500 or a similar index. For example, the Maryland state retirement system maintains an equity index fund designed to replicate performance of the S&P 500 index. The index fund as of February 28, 1990 totalled $1,861 billion out of a total equity program of $3,380 billion. The entire MSRPS investment effort is $11,068 billion in size.

The $1,861 billion equity index fund is rebalanced monthly to account for the addition of new funding and for interim changes in market value. Rebalancing is carried out expressly to accomplish replication of the S&P 500 indicator.

Rebalancing can at times inadvertently trigger realization of short-term capital gains. It is not the intent of rebalancing to produce capital gains but a by-product. Should a sponsor for tactical reasons decide to reduce the size of its index fund (in order to reduce equity exposure, for instance), then rebalancing could be extensive. Correspondingly, capital gain realizations could likewise be extensive.

Investors in these accounts are trying to follow the market, not beat it to do so holdings in these accounts must be rebalanced on a frequent basis, e.g. monthly. This will invariably produce some short term gains which, under the proposals being considered today, would be taxed. Thus, public pension funds—state and local monies would become subject to federal taxes or, to avoid such taxes, public fund management policies might have to be altered solely to respond to federal tax policy.

NAST has only recently begun to examine this issue. working with other groups involved in public pension matters, NAST will have additional information to present to you in the near future. The council of institutional investors has examined this issue closely and has reached the following conclusions.

First, there appears to be a misunderstanding to the basic assumptions of our investment philosophy. We understand that no investors have a more critical need for a long-term perspective than our pension funds.

Our fiduciary responsibility under the law is solely to provide promised benefits to our individual members.

Second, and with this legal burden in mind, we do not madly flip our portfolios over by the minute like short order cooks in a pancake house. I understand the council of institutional investors has given to your staff turnover and holding period data for council members, and the numbers speak for themselves. We pull market averages down, not up; and our turnover has decreased in each of the last two years despite dramatically lower transaction costs. Pension funds tend to be long-term investors.

To give you one typical example: the giant New York City funds have held over 69% of their equities for more than six years each and have held their largest holdings over 20 years. In another example, the largest public pension fund in the nation the California public employees' retirement system has an annual turnover rate of less than five percent and an average holding period of eight years.

It is suggested, despite significant data to the contrary, that we are not only short-term oriented, and sack our managers if performance lags for even a quarter, but that our short-term perspective prevents American companies from pursuing long-term plans and thus harms our international competitiveness. If this were true, we would be the first to complain.

The council of institutional investors has submitted numerous well-respected studies to you documenting that:

—institutional investors do strongly value a company's long-term potential;

—indeed, they tend to have a longer-term outlook that most corporate executives; and

—the investment time horizons of institutional investors, whether long or short, almost invariably do not affect, positively or negatively, corporate planning capacity.

We have repeatedly requested that those who deny these points, produce evidence to the contrary. We are given no facts nor studies and are offered instead two anecdotes for companies announcing R&D expenditures on days in which their stock prices fell.

Stock prices fall for a variety of reasons, and not all R&D expenditures are in the long-term interest of a company. A transaction tax, on the other hand, is a severe remedy, and one that we have considerable trouble accepting in the absence of genuine evidence of a genuine problem.

Third, finally and most fundamentally: transaction taxes harm rather than enhance, the health of the economy in both the short and long-term. they:

—make market crashes or crashettes more likely because investors will be inhibited from responding to market fundamentals in the gradual and orderly ways (tending instead to delay decisions until suddenly they all leap);
—make it less likely that investors will funnel capital to its most productive uses;
—raise the cost of capital generally;
—fall most heavily on the savings of the average American, who, both individually and through his or her pension fund, makes up the majority of the market.

Perhaps this final point can be made most clearly another way. In a highly acclaimed recent book titled *How The West Grew Rich*, the authors observed that:

> At the end of the 16th century, most people in western Europe were poor. Dirt poor. Even the richest lacked the medicine, diet, and warmth, education, travel and entertainment available to all but the very neediest in the modern west. Furthermore, 100 years ago China and the Islamic world were probably better off than Western Europe. Today, fortunes are reversed: 80% to 90% of westerners are well-off. And only those Asian nations that have copied the west even approach it in riches.

The book analyzes a massive amount of evidence to explain why this reversal happened. It concludes that the west grew rich by allowing its economic sector the autonomy to experiment on products, technology, and organization.

If we want a healthy economy and healthy pension funds, we must not only accept change, we must encourage it—we must certainly not tax it. We must seek lower interest rates and stable exchange rates. We must increase government's commitment to education and infrastructure. We must accept that while some jobs are continually eliminated, they are consistently replaced, often with more pleasant and high paying ones (a fact that how the west grew rich documents in some detail). We must avoid suggestions that a long-term perspective means freezing the economy the way it is and keeping it there for 30 years—eastern Europe is rejecting just this model, as the far east previously did considerably to its profit. We must also avoid any suggestion that there is a proper or a gentlemanly holding period that patriotic investors must blindly adhere to in order to demonstrate their earnest commitment to the long term. We live in a much more dynamic world than that and must keep it so if the "long-term" is going to be worth arriving at.

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COMPETITIVE DECLINE AND CORPORATE RESTRUCTURING: IS A MYOPIC STOCK MARKET TO BLAME?

by J. Randall Woolridge,
Pennsylvania State University

MYOPIC MARKETS OR MYOPIC MANAGERS?

In recent years many observers have attributed the competitive decline of U.S. industry in world markets to corporate management's preoccupation with short-term performance. In a classic *Harvard Business Review* article, for example, Robert Hayes and William Abernathy accused management of being short-sighted and not keeping their companies technologically competitive over the long run.[1] The emphasis on short-term profitability is predicted by some to have disastrous long-term implications, leading ultimately to the "de-industrialization of America."[2]

Corporate managers, however, respond to this charge by putting the blame on capital markets. Investors, they argue, are short-sighted, compelling management to sacrifice long-term investment and maximize current earnings—or else face the threat of takeover. Andrew Sigler, CEO of Champion International, has become one of the most prominent spokesmen for this view. "There is intense pressure for current earnings," Sigler says, "So the message is: Don't get caught with long-term investments. And leverage the hell out of yourself. Do all the things we used to consider bad management."[3] And Sigler's statement appears to have struck a sympathetic chord in many of America's top executives. In a survey of 100 CEOs of major corporations, 89 agreed that America's competitive edge has been "dulled" by its failure to emphasize long-term investment, and 92 percent of this group felt that Wall Street's preoccupation with quarterly earnings was the cause.[4]

In the meantime, academic theory suggests that investors have strong incentives to take the long view of corporate performance; and what evidence we have supports this theory. Michael Jensen, in fact, has turned the popular "short-term" argument on its head by asserting that "managers may behave myopically but markets do not." As Jensen argues,

> *There is little formal evidence on the myopic managers issue, but I think this phenomenon occurs. Sometimes it occurs when managers hold little stock in their companies and are compensated in ways that motivate them to take actions to increase accounting earnings rather than the value of the firm. It also occurs when managers make mistakes because they do not understand the forces that determine stock values. . .There is much evidence inconsistent with the myopic markets view, and none that supports it.*[5]

The purpose of this article, then, is to evaluate current claims about the allegedly destructive role of the capital markets in corporate restructuring and the competitive decline of U.S. industry. My approach is to review the existing theory and evidence, and then introduce two further pieces of evidence. The first examines the market response to announcements of corporate long-term investments of several kinds (joint ventures, major capital expenditures, product strategies, and largescale R & D projects) to

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[1] Robert H. Hayes and William J. Abernathy, "Managing Our Way to Economic Decline," *Harvard Business Review*, (July-August 1980), pp. 67-77.

[2] "Will Money Managers Wreck the Economy," *Business Week*, (August 13, 1984), pp. 86-93.

[3] See Judith H. Dobrznyski, "More Than Ever, It's Management for the Short Term," *Business Week*, (November 24, 1986), pp. 92-3.

[4] Business Bulletin, *Wall Street Journal*, (June 12, 1986), p 1.

[5] Michael Jensen, "The Takeover Controversy: Theory and Evidence," *Midland Corporate Finance Journal*, Volume 4 Number 2 (Summer 1986), p. 11.

WITH FEW EXCEPTIONS, THE SHORT-TERM THEORY OF MANAGERIAL AND CAPITAL MARKET BEHAVIOR IS INCONSISTENT WITH THE

see if the markets actually penalize companies for committing capital to undertakings with distant, uncertain payoffs. The second is a less formal attempt to estimate the fraction of current stock prices that reflect corporate cash flows expected beyond a five-year horizon. Taken together, these two experiments provide suggestive evidence about the time horizon used by investors in valuing securities.

SOME BACKGROUND

The capital markets in this country have become dominated by large financial institutions. Recent statistics indicate that pension and mutual fund managers now control some 60 percent of all common shares and, on average, account for 80 to 90 percent of all daily trades.[6] According to the popular "short-term argument," the quarter-to-quarter performance figures of institutional investment managers, which are often reported in the financial press, are very important in retaining old accounts and in attracting new investors. Presumably, in pursuit of competitive quarterly performance figures, money managers follow investment strategies that place a premium on short-term corporate performance, which forces corporate managers to focus constantly on quarter-to-quarter earnings per share at the expense of long-term competitive growth. As Peter Drucker writes (in a *Wall Street Journal* editorial entitled "A Crisis of Capitalism"):

> *Everyone who has worked with American managements can testify that the need to satisfy the pension fund manager's quest for higher earnings next quarter, together with the panicky fear of the raider, constantly pushes top managements toward decisions they know to be costly, if not suicidal, mistakes. The damage is greatest where we can least afford it: in the fast-growing middle-sized high-tech or high-engineering firm that needs to put every available penny into tomorrow—research, product development, market development, people development, service—lest it lose leadership for itself and for the U.S. economy.*[7]

The short-term orientation of managers is said to manifest itself in several ways. Managers are accused of being risk averse, forsaking investments with longer-run payoffs such as research and development expenditures. They are blamed for boosting short-term earnings, potentially at the expense of long-term growth, through financial innovations such as sale/lease backs and common stock repurchases. In addition, managers are said to concentrate their efforts in merger and acquisition activity and other "financial games," instead of devoting their attention to strategic product market issues. Other common charges against management are these: strategic decisions in product development are purely market-driven, showing little imagination; managers are biased towards buying productive resources and processes–from others and against developing new productive resources and processes to gain competitive advantage; and, finally, innovation is discouraged by the short-term orientation of managers, which instead fosters imitation and backward integration because of their more predictable results.

The debate over the investment time horizon of the market, and its alleged role in the competitive decline of U.S. industry, is only one strand of a much larger contemporary issue in corporate America: namely, corporate governance. Managerial performance in creating value for shareholders has come under close scrutiny in the markets, and those firms which fall short risk being taken over. Indeed, the market for corporate control has heated up with growing numbers of hostile tender offers and proxy fights.

Managers have responded in essentially two different ways. One response has been to restructure their companies themselves through various actions aimed at increasing shareholder value. These restructurings have included redeploying or selling assets (and thereby allowing these resources to be employed in higher-valued uses), divesting or selling off poorly performing divisions (again, to some other corporate user who anticipates improving performance), decreasing uneconomic overhead, strategically repositioning primary business units, and making efficient use of cash and leverage (which often includes some form of settlement with shareholders),

The second class of managerial reactions to the increase in takeover activity has been to seek protection from the corporate control market through contracting agreements with corporate boards, and

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[6] For statistics and a discussion of the dominance of institutional investors in the markets, see Michael Blumstein, "How the Institutions Rule the Market," *The New York Times*, (November 25, 1984), Section 3, p.1.

[7] Peter Drucker, "A Crisis of Capitalism," *The Wall Street Journal*, (September 30, 1986), p.31.

WITH FEW EXCEPTIONS, THE SHORT-TERM THEORY OF MANAGERIAL AND CAPITAL MARKET BEHAVIOR IS INCONSISTENT WITH THE CONTEMPORARY LITERATURE IN FINANCE AND ECONOMICS.

through regulatory proposals that alter the regulation of tender offers and change shareholder voting procedures and other corporate governance rules. Overall, as managers have come under greater pressure to perform on behalf of shareholders, the relationship between management and shareholders has become increasingly strained.[8]

Many observers have debated the merits of the current restructuring of corporate America. Managers argue that they must balance the interests of stockholders with those of other corporate stakeholders, such as employees, suppliers, customers, and communities. Hicks B. Waldron, chairman of Avon Products, makes the point this way:

> *We have 40,000 employees and 1.3 million representatives around the world. We have a number of suppliers, institutions, customers, communities. None of them have the democratic freedom as shareholders do to buy or sell their shares. They have much deeper and more important stakes in our company than our shareholders.*[9]

As such, management claims it must be protected from "overzealous" institutional stockholders who demand immediate results—and from corporate raiders and their allies, Wall Street arbitrageurs, who stand willing to pounce on firms whose short-term performance and stock price falters.

Managers contend that they need patient investors who are willing to accept the risks of long-term equity investment.[10] To illustrate this point, they cite such statistics as the relatively high turnover rates on institutional stock portfolios (over 60 percent, on average, in recent years) and stock returns in Japan, where stocks have grown over sixfold since 1970 (and turnover rates are one-third those of U.S. institutions).[11] Andrew Sigler, cited earlier, is somewhat more succinct in his evaluation of the short-term perspective of institutional investors: "What right does someone who owns the stock for an hour have to decide a company's fate. That's the law, and it's wrong."[12]

According to T. Boone Pickens, however, management's short-term theory is "pure hokum." "Increasing acceptance of the short-term theory," Pickens argues,

> *has freed executives to scorn any shareholders they choose to identify as short-termers. Executives aim their contempt not only at the initiators of takeover attempts but at the arbitrageurs and the institutional investors who frequently trade in and out of stocks.*[13]

Institutional investors themselves vigorously object to the notion that they are "only short-term" investors and insist that they are only interested in portfolio value gains which, given the forward-looking nature of the market, result from enhanced future prospects.[14] At the same time, however, they profess to be "fed up" with corporate managers who mismanage assets and then hide behind the "cloak" of social responsibility. It goes without saying that institutional investors oppose management entrenchment procedures—the proxy process, poison pills, greenmail, golden parachutes, staggered boards, and dual classes of common stock—all of which serve to reduce the discipline imposed on management through the market for corporate control. In articulating what is probably the position of most institutional investors, Richard M. Schlefer of the College Retirement Equities Fund says, "We view tender offers as a kind of free, competitive market for management. The best managers will end up running a company."[15]

THE MARKET RESPONSE TO STRATEGIC INVESTMENT DECISIONS

With few exceptions, the short-term theory of managerial and capital market behavior is inconsistent with the contemporary literature in finance and

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[8] For example, see C. Power and V. Cahan, "Shareholders Aren't Just Rolling Over Anymore." *Business Week*, (April 27, 1987), pp. 32-33.

[9] See Bruce Nussbaum and Judith Dobrznyski, "The Battle for Corporate Control," *Business Week*, (May 18, 1987), pp. 102-109.

[10] John G. Smale, chairman and CEO of Proctor & Gamble Co., recently wrote on the responsibilities of shareholders. Whereas he does not specify what hareholders' responsibilities actually are, he makes the distinction between 'traditional shareholders' and 'temporary owners', who "... play a role that can lead to he acquisition of corporate assets through creative financing for the purpose of eaping a quick profit." See John G. Smale, "What About Shareholders' Responsibility?," *The Wall Street Journal*, (October 16, 1987), p.20.

[11] For an extended version of the "patient investor" argument, see Donald rey, "The U.S. Needs Patient Investors," *Fortune*, (July 7, 1986), 125-126; and Karen ennar, "Is the Financial System Shortsighted?," *Business Week*, (March 3, 1986), pp. 2-3.

[12] B. Nussbaum and J. Dobrznyski, "The Battle for Corporate Control," *Business Week*, (May 18, 1987), pp. 102-109.

[13] T. Boone Pickens, "Professions of A Short-Termer," *Harvard Business Review*, (May-June 1986), pp. 75-79. A rebuttal to Pickens arguments is provided in W. Law, "A Corporation Is More Than Its Common Stock," *Harvard Business Review*, (May-June 1986), pp. 80-83.

[14] Seely argues that corporations should actually court institutional investors. He claims that higher levels of institutional common stock ownership leads to higher stock liquidity and lower market-related volatility. Furthermore, he maintains that "overowned" stocks have outperformed "underowned" stocks, and that "underowned" stocks are more vulnerable to takeovers since these companies tend to have a low profile on Wall Street and therefore have been neglected by institutions. See Michael Seely, "In Praise of Institutional Investors," *Fortune*, (April 15, 1985), p. 167.

[15] See Bruce Nussbaum and Judith H. Dobrznyski, "The Battle for Corporate Control," *Business Week*, (May 18, 1987), pp. 102-109.

THE ABILITY OF STRATEGIC INVESTMENT DECISIONS TO GENERATE POSITIVE NET PRESENT VALUES RESTS ON "IMPERFECTIONS" IN PRODUCT AND FACTOR MARKETS.

economics. Economic theory suggests that an active market for managerial labor and corporate control compels managers to maximize shareholder wealth over the long-run which, among other things, entails making strategic investment decisions today which ensure growth tomorrow. In addition, many empirical studies have demonstrated that the capital markets, full of institutional as well as individual investors looking to take advantage of arbitrage opportunities, do not systematically misprice securities.

Therefore, security prices are presumed to provide an unbiased estimate (that is, neither too high nor too low, on average) of long-term investment value. Consequently, whereas managers continue to make their case in the financial press that long-term investments are "hazardous" in today's capital markets, most economists would be reluctant to blame the capital markets for inducing myopic behavior by managers.

Economic Theory and Real Corporate Investment

According to traditional valuational theory, the market value of a firm is equal to the sum of (a) the net present value of cash flows generated from assets in place and (b) the net present value of expected cash flows from investment opportunities that are expected to be available to and undertaken by the firm in the future. The market value of a firm changes as the market receives either general market or firm-specific information which changes the market's expectations about either (a) or (b) above.

As such, upon announcement of corporate strategic investment decisions, the market provides its immediate "best guess" about the effect of these strategic investment decisions on the present value of all future cash flows. In a competitive and efficient market, arbitrageurs should prevent any systematic mispricing of securities.

In economists' model of a perfectly competitive industry, entry and exit are assumed to be costless, products are undifferentiated, and there are increasing marginal costs of production. In such an environment, products are sold strictly on the basis of price, each firm produces up to the point where price equals marginal cost, and the long-run industry equilibrium is reached in which price equals average cost (including a charge for capital, or "normal" level of profit). In equilibrium, total revenues equal total costs for the industry and individual firms alike; and because costs include the required return on the capital employed by each firm, in the long-run actual and required returns on capital are equal.

In perfectly competitive factor and product markets, then, strategic investment decisions with positive net present values do not exist; that is, the factors associated with strategic investment decisions are priced in factor and product markets void of imperfections such that the net present value of these decisions is zero. If a strategic investment decision is perceived to have a positive net present value, it instantaneously attracts new entrants to the industry, which in turn increases factor prices and capacity and drives product prices down. Higher factor prices and lower product prices reduce returns to all the firms, which forces weaker firms to leave the industry. With fewer competitors, factor prices decline and product prices rebound, increasing returns for the surviving firms until once again actual and required returns are equal. As such, in this perfectly competitive environment, the search by corporate planners for strategic investments with positive net present values is doomed to failure.

The ability of strategic investment decisions to generate positive net present values rests, then, on "imperfections" in product and factor markets. It is these "imperfections" that permit one firm to gain competitive advantage over others in its industry. Firms can gain competitive advantage through strategic decisions which allow the firm to become the low-cost producer or to differentiate its product on the basis of service or quality such that customers are willing to pay a premium for the product. These competitive advantages form "barriers to entry" to potential entrants and result in an imperfectly competitive market in which strategic investment decisions with positive net present values are possible.[16]

The Hypotheses

In this study, I am defining strategic investment decisions as those corporate resource allocations that involve a substantial commitment of capital with the expectation of an uncertain payoff in the future.[17] By definition, therefore, these decisions are made in anticipation of increasing long-term growth at the expense of lower short-term earnings.

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[16] Alan Shapiro, for example, has identified five major areas where strategic investment decisions can create, preserve, or enhance barriers to entry and generate positive net present values. These areas are (1) economies of scale; (2) product differentiation; (3) cost advantages; (4) access to distribution channels; and (5) government policy. (See Alan Shapiro, "Corporate Strategy and the Capital Budgeting Decision," *Midland Corporate Finance Journal*, (Spring 1985), pp. 22-36.)

The stock market reaction to announcements of strategic investment decisions can be thought of as having two components: (1) a price reaction which reflects general, overall factors influencing managerial strategic decisions and firm valuation; and (2) price reactions to individual situations in which the market reacts positively or negatively to a strategic announcement based on (a) the information available to investors at the time of the announcement (for example, to what extent was the strategy announcement expected?) and (b) the perception of the market regarding the soundness of the strategic investment decision.

How, then, should the market be expected to respond to such announcements? I have laid out the alternative hypotheses as follows:[18]

Positive Stock Price Reaction

Shareholder Value Maximization (SVM) - Traditional finance theory posits that managers seek to maximize the market value of the firm. According to this hypothesis, managers are compelled by market forces to make strategic investment decisions aimed at maximizing shareholder value. Therefore, strategic investment announcements are interpreted by investors as managerial decisions with expected positive net present values and therefore are accompanied by significantly positive abnormal stock returns;

Neutral Stock Price Reaction

Highly Competitive Markets (HCM) - The ability of strategic decisions to generate positive net present values and to increase stock prices rests on imperfections in factor and product markets which permit a firm to gain competitive advantage over others in the industry. However, equilibrium in a perfectly competitive market requires that the level of factor and product prices be set such that strategic decisions cannot generate positive net present values. Whereas the assumptions of a perfectly competitive world are unduly restrictive, it is possible that, in a highly competitive market, products and factors are priced so as to virtually eliminate excess returns. In such a market, strategic investment decisions with positive net present values would be rare, and thus strategic announcements would be accompanied by no change in stock prices; and

Rational Expectations Market (REM) - In a rational expectations market environment, security prices reflect investors' expectations that managers will undertake strategic investments to provide for future growth and increases in shareholder value. As such, according to this hypothesis, security prices do not react to announcements of strategic investment decisions, even though investors' may believe that these investments have positive net present values; and

Negative Stock Price Reaction

Myopic Stock Market (MSM) - Many observers have argued that investors in the U.S., especially the large and powerful financial institutions, are too short-sighted, focusing on quarter-to-quarter earnings and thereby preventing managers from pursuing strategies aimed at long-term competitive advantage and growth. According to MSM hypothesis, strategic investment announcements which involve decisions

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[17] Research into the valuation impact of strategic investment decisions is concentrated in the area of intercorporate acquisitions. For a review of the evidence on intercorporate mergers and tender offers and shareholder returns, see Michael Jensen and Richard Ruback, "The Market for Corporate Control: The Scientific Evidence," *Journal of Financial Economics*, (April 1983), pp. 323-329.

Several recent studies, however, have evaluated the market's response to the kinds of strategic investment decisions that I am considering in this paper. For example, John McConnell and Chris Muscarella examined the reaction of stock prices to 658 announcements of increases and decreases in the dollar amount of planned capital expenditures and discovered that announcements of increases (decreases) in capital budgets are associated with significantly positive (negative) abnormal stock returns for industrial firms. (See John McConnell and Chris Muscarella, "Corporate Capital Expenditures Decisions the Market Value of the Firm," *Journal of Financial Economics*, (July 1985), pp. 399-422.) John McConnell and Tim Nantell investigated the relationship between joint venture formation and announcement day stock returns. Their sample included 210 firms involved in 136 joint ventures over the 1972-79 time period. They discovered joint venture formations to be associated with significantly positive announcement day returns. (See John McConnell and Timothy Nantell, "Corporate Combinations and Common Stock Returns: The Case of Joint Ventures," *Journal of Finance*, (June 19850 pp. 519-536.) Greg Jarrell, Ken Lehn, and Wayne Marr analyzed the relationship between research and development (R&D) expenditures and stock prices as part of a larger study of institutional stock ownership, long-term investments, and tender offers. Using a sample of 62 R&D announcements taken from the *Wall Street Journal*, over the 1973-83 period, they found these announcements to be associated with significantly positive stock returns. (See Greg Jarrell, Ken Lehn, and Wayne Marr, "Institutional Ownership, Tender Offers, and Long-Term Investments," The Office of the Chief Economist, Securities and Exchange Commission (April 19, 1985).)

[18] Several comments on these hypotheses and tests are in order: (1) in the tests which follow, the stock price reaction to strategic investment announcements may reflect some or all of the specific and general considerations discussed here. However, only the dominant general factor influencing stock prices can be determined. Specific factors are presumed to average out over the sample; (2) While the lack of any statistically significant stock price movement is consistent with both the HCM and the REM hypotheses, it is also consistent with other joint and confounding hypotheses. As such, strict inferences in this case are not possible; and (3) it is arguable that a negative strategic announcement/stock return relationship is also consistent with some theories of managerial behavior which conflict with the SVM hypothesis. An alternative interpretation of negative stock returns is that managers may be engaging in activities with negative net present values. These may result from traditional agency problems in which managers' interests conflict with those of stock holders. For capital expenditures, this argument is similar to Malatesta's size-maximization hypothesis for stock returns of acquiring firms in mergers. As such, this hypothesis would be supported in this study if stock prices are discovered to react negatively to capital expenditures announcements. See Paul Malatesta, "The Wealth Effect of Merger Activity and the Objective Functions of Merging Firms," *Journal of Financial Economics*, (April 1983), pp. 155-181.

TABLE 1
STRATEGIC INVESTMENT ANNOUNCEMENTS:

Category		Number of Announcements
Joint Venture Formation		161
Research and Development	39	
Shared Assets/Resources	35	
Asset Construction	87	
Research and Development		45
Advances	27	
Initial Expenditures	18	
Product Strategies		168
New Product/Old Business Line	105	
New Product/New Business Line	39	
Old Product/New Geographic Market	24	
Capital Expenditures		260
General Capacity Expansion Construction	194	
Plant Modernization Construction	31	
Capital Budgets Increases	35	

with long-term payoffs (such as research and development and capital expenditures) at the risk of reducing short-term earnings result in a significant decrease in stock prices.

The Data

To examine the relationship between strategic investment decision announcements and stock prices, I gathered a large sample of strategic investment announcements from articles appearing in the *Wall Street Journal*. With the aid of a computer, I searched the "What's News" column (over the period June 1972 to December of 1984) for announcements that appeared to indicate a major corporate strategic investment. When a likely candidate was located, I then read the article to determine the strategic nature of the announcement and whether or not other significant information was also published. In cases where the announcements included other information concerning a firm's sales or earnings, or if other announcements concerning sales or earnings appeared in the *Wall Street Journal* within one day of the strategic investment decision announcement, they were excluded from the sample.

After this winnowing process, I was left with 634 strategic announcements made by 347 different companies operating in 81 different industries.[19] These announcements were then classified into one of four general areas based on their strategic orientation: (1) joint ventures, (2) research and development expenditures, (3) product strategies, and (4) capital expenditures for expansion or modernization. These four general categories were refined further into more specific subcategories (all of which are listed in Table 1).

The four general categories may be summarized as follows:

Joint ventures: Joint ventures are typically employed when two or more firms lack a necessary component to compete in a particular market. The purposes behind joint venture formation take many forms, which range from joint research projects aimed at developing new technology, to joint production projects to take advantage of the engineering strengths of more than one firm, to joint marketing efforts to gain access to new markets. Management and development costs are usually shared by the firms, as are the profits from the venture. Joint ventures reduce the risk and potential financial losses inherent in new projects, but at the expense of reduced rewards if the project proves to be successful.[20]

The sample of joint venture formations was further broken down according to the purpose behind formation, e.g., research and development, shared resources, and asset construction.

Research and development expenditures: A number of studies report that R&D expenditures exert a

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[19] By year, the sample breaks down as follows:

Year	No.	Year	No.	Year	No.	Year	No.	Year	No.
1972	40	1975	35	1978	56	1981	32	1984	44
1973	93	1976	28	1979	25	1982	49		
1974	33	1977	84	1980	40	1983	75		

As may be expected, the annual number of the strategic investment decision announcements is closely related to the level of overall economic activity.

[20] Strategists like the joint venture concept. According to one theorist, joint ventures are one of twelve "grand strategies" which "serve to provide the basis for achieving long-term objectives" (see J. Pearce, "Selecting Among Alternative Grand Strategies," *California Management Review* (Spring 1982), pp. 23-31). Michael Porter describes joint ventures as a type of "long-term alliance which broadens the effective scope of the firm's value chain" (Michael Porter, *Competitive Advantage* (NY: The Free Press, 1985).

TABLE 2
COMMON STOCK RETURNS AROUND STRATEGIC INVESTMENT ANNOUNCEMENTS

Day	Mean Raw Return	Percent Greater Than 0	Market-Adjusted Return	T-Stat	Cumulative Market-Adjusted Return
N = 634					
− 1	+ 0.360	46.53	+ 0.295	+ 2.95	+ 0.360
0	+ 0.350	51.42	+ 0.355	+ 4.27	+ 0.710
+ 30	—	—	—	—	+ 0.984
Panel A: Joint Venture Formations N = 161					
− 1	+ 0.526	48.45	+ 0.384	+ 1.92	+ 0.384
0	+ 0.447	51.55	+ 0.399	+ 2.02	+ 0.783
+ 30	—	—	—	—	+ 1.412
Panel B: Research and Development Expenditures N = 45					
− 1	+ 1.042	57.78	+ 0.944	+ 2.47	+ 0.944
0	+ 0.400	48.89	+ 0.251	+ 0.93	+ 1.195
+ 30	—	—	—	—	+ 1.456
Panel C: Product Strategies N = 168					
− 1	+ 0.421	50.60	+ 0.402	+ 2.29	+ 0.402
0	+ 0.487	54.76	+ 0.440	+ 2.84	+ 0.842
+ 30	—	—	—	—	− 0.350
Panel D: Capital Expenditures N = 260					
− 1	+ 0.099	40.77	+ 0.058	+ 0.36	+ 0.058
0	+ 0.194	49.62	+ 0.290	+ 2.45	+ 0.348
+ 30					+ 1.499

strong positive impact on profitability.[21] But, a significant time gap exists between when the expenditures are made and when they affect profitability. One study found that peak profits accrued four to six years after R&D spending occurred.[22] However, the returns from R&D expenditures are uncertain and can fluctuate considerably from year to year.

The sample of R&D announcements were further classified according to information contained in the announcement: some announcements involved expenditures to new R&D projects, while others provided details on commitments to ongoing R&D projects and programs.

Product strategies: The Development and launching of new products, as well as entrance into new markets with existing products, are strategic decisions which are essential for long-run growth. However, they both involve a commitment of resources and, as such, are risky and costly in the short run.

The product strategy announcements fall into three categories: new product introductions into old business lines, the introduction of new products into new business lines, and the introduction of old products into new geographic markets.

Capital expenditures: Like other strategic investment decisions, the commitment of funds for capital projects is necessary to ensure the long-term vitality of a business firm. Capital expenditures are provided for projects such as capacity expansions, plant modernization, as well as general expenditures to update equipment. Like R&D expenditures, the returns on capital expenditures are uncertain and may not come until some time in the future. In addition, after a capital project is undertaken, short-term earnings will be depressed until the project is completed and begins to generate revenues or reduce operating costs.

Capital expenditures are further categorized as follows: general capacity expansion construction (including mining and exploration), plant modernization projects, and general increases in capital budgets.

The Results

With the aid of a computer, I calculated stock price changes in response to the entire sample of stra-

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[21] See H. Grabowski and D. Mueller, "Industrial Research and Development, Intangible Capital Stocks, and Firm Profit Rates," *Bell Journal of Economics*, (Fall 1978), pp. 328-342; Z. Griliches, "Productivity, R&D, and Basic Research at the Productivity Rates," *American Economic Review*, (May 1985), pp. 215-218; and Edwin Mansfield, "How Economists See R&D," *Harvard Business Review*, (November-December 1981), pp. 98-106.

[22] Sherer, cited in note 21.

THE TWO-DAY MARKET RETURNS TO 45 ANNOUNCEMENTS OF R&D EXPENDITURES AVERAGED A POSITIVE 1.2 PERCENT.

SOME EXAMPLES OF THE MARKET'S RESPONSE TO STRATEGIC ANNOUNCEMENTS

Company	Date	Nature of Announcement	2-Day Return
Imperial Chemical	3/9/77	Plan to build two plants in Britain at total cost of $181 million	5.51%
Union Camp	8/31/77	Plan to spend $250 million to double output of linerboard mill	4.13%
Reynolds Metals	9/15/78	Plan to spend $70 million to expand sheet-and-plate plant	2.01%
Washington Post	5/22/78	Joint venture to build and operate newsprint mill costing $100 million	2.50%
Motorola	8/12/81	Plan to spend $120 million to expand semiconductor plant in Scotland	2.42%
Westinghouse	4/2/82	Increased capital spending by 33%, to $800 million, to enter cable TV market	1.56%
J.C. Penney	2/1/83	Plan to spend $1 billion over next 5 years to modernize 450 stores	7.15%
DuPont	8/12/83	Plan to spend $100 million on R&D to improve automotive/industrial coatings	2.54%
PSA	11/17/83	Purchase of 20 British Aerospace 100-seat jets for $300 million	2.23%
Wang Labs	4/18/84	Plan to acquire 15% interest in InteCom to pursue joint marketing & product dev.	6.41%
Federal Express	7/30/84	Plan to spend $1.2 billion over next 10 years to expand new ZapMail service	2.27%

tegic announcements both in the two-day period surrounding the public announcement and over a period of 30 trading days following the announcement. These returns were adjusted for the overall market return (as measured by the return for the S&P 500), and then averaged across the entire sample. Average, market-adjusted returns were also calculated for each of the four categories of investment described above.[23] The results are summarized in Table 2.

All Strategic Investment Announcements: For the entire sample of 634 strategic investment announcements, the market-adjusted returns (MMARs) over the two-day period surrounding the announcement averaged a positive 0.7 percent. (The MMARs for days −1 and 0 were .295% ($t = 2.95$) and .355% ($t = 4.27$), respectively, which are the two largest MMARs over the 32 day period (day −1 to day +30).) Over this 32-day period these stocks outperformed the S&P 500 by about 1 percent.

Joint Venture Formations: As shown in Table 2, the average, two-day, market-adjusted return to 161 announcements of joint ventures was a positive 0.8 percent, roughly the same as the market response to the broad sample. Over the thirty-two day period following (and including) the announcement days, the cumulative excess market return to joint venture formations was 1.4 percent. (The largest positive response to subcategories of joint ventures (not shown in the Table) were those in which assets or resources were to be shared.)

Research and Development Expenditures: The two-day market returns to 45 announcements of R&D expenditures averaged a positive 1.2 percent (reflecting MMARs for day −1 and day 0 of .944% and .251%). As in the case of joint ventures and the overall sample, there is no evidence of stock price declines in the subsequent 30 days.

The subsample statistics indicate that the announcements of expenditures on ongoing R&D programs, as opposed to new projects, were received

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[23] In all cases, the announcements appeared in the *Wall Street Journal* on day 0. However, in some instances, the announcements were actually made on day −1. Therefore, returns on these two days should provide an indication of the market's evaluation of the announced strategic investment decision.

UPON ANNOUNCEMENT OF CORPORATE STRATEGIC INVESTMENT DECISIONS, THE MARKET PROVIDES ITS IMMEDIATE "BEST GUESS" ABOUT THE EFFECT OF THESE STRATEGIC INVESTMENT DECISIONS ON THE PRESENT VALUE OF ALL FUTURE CASH FLOWS.

TABLE 3
LONG-TERM VALUE INDEXES DOW JONES INDUSTRIALS MARCH 1988

				Earnings Per Share			
Company	Stock Price	Beta	P/E	Current Earnings	Earnings Yield	Projected Earnings Growth	Pres Val Next 5 Yr Earnings
Allied-Signal	$32.75	0.95	13	$2.60	7.9%	5.5%	$11.38
Alcoa	$45.38	1.25	11	$4.14	9.1%	17.5%	$24.55
American Express	$26.00	1.45	21	$1.25	4.8%	16.5%	$7.12
AT&T	$29.38	0.80	16	$1.85	6.3%	16.5%	$11.02
Bethlehem Steel	$19.88	1.45	NM	$0.25	1.3%	NMF	
Boeing Company	$47.88	0.95	16	$3.00	6.3%	10.5%	$15.05
Chevron Corp.	$43.75	0.95	18	$2.50	5.7%	6.5%	$11.24
Coca-Cola	$38.00	0.95	16	$2.45	6.4%	11.0%	$12.46
DuPont	$86.75	1.15	12	$7.39	8.5%	12.0%	$38.09
Eastman Kodak	$41.38	0.85	12	$3.55	8.6%	23.5%	$25.36
Exxon Corp.	$42.25	0.75	13	$3.20	7.6%	4.5%	$13.80
General Electric	$43.88	1.05	18	$2.43	5.5%	11.0%	$12.27
General Motors	$70.00	1.00	7	$10.00	14.3%	3.0%	$40.69
Goodyear Tire	$58.13	1.20	8	$7.70	13.2%	23.0%	$52.94
IBM	$116.13	0.95	13	$8.72	7.5%	12.5%	$46.18
International Paper	$43.25	1.25	12	$3.60	8.3%	22.5%	$24.34
McDonald's Corp.	$47.38	1.00	17	$2.85	6.0%	15.5%	$16.31
Merck & Co.	$163.25	0.90	24	$6.68	4.1%	22.0%	$45.72
Minnesota Mng.	$59.00	1.05	15	$3.95	6.7%	13.5%	$21.34
Navistar Int'l.	$5.50	1.25	25	$0.22	4.0%	NMF	
Phillip Morris	$93.00	1.05	12	$7.80	8.4%	21.0%	$51.45
Primerica	$29.13	1.00	9	$3.30	11.3%	17.5%	$19.91
Procter & Gamble	$82.63	0.85	18	$4.59	5.6%	11.0%	$23.50
Sears & Roebuck	$36.25	1.30	8	$4.50	12.4%	12.0%	$22.96
Texaco	$42.25	0.75	26	$1.65	NMF	2.0%	
USX Corp.	$32.88	0.95	26	$1.25	3.8%	NMF	
Union Carbide	$23.88	NMF	11	$2.17	9.1%	NMF	
United Technologies	$40.63	1.10	9	$4.35	10.7%	9.5%	$21.02
Westinghouse	$53.25	1.30	10	$5.12	9.6%	12.5%	$26.48
Woolworth (F.W.)	$45.13	1.10	12	$3.80	8.4%	14.0%	$20.74
Mean*	$55.67	1.04	14	$4.45	8.1%	13.8%	$24.64

*All Mean figures exclude companies with incomplete data

**Key assumptions—Risk-free interest rate equals 8.00%
—Market risk premium equals 2.50%

more positively by the market.

Product Strategies: For 168 announcements of product strategy announcements, the market's two-day response averaged 0.8 percent, again mirroring the market reaction to the broad sample. (In addition, the returns for the two-day event period represent the largest average price movements over the entire 32-day period.) Most of these gains, however, are lost over the following 30-day period, and the cumulative average return becomes slightly negative.

The subsample results indicate that the market responds positively to the announcements of new product introductions, be they in old or new business lines. The most positive market response is associated with the introduction of new products in old business lines.

Capital Expenditure Announcements: For 260 announcements of large capital spending programs, the average two-day, market-adjusted return was 0.35 percent. (The return of .29 percent on day 0 is the largest over the 32-day period.) In addition, these stocks outperformed the S&P 500 by almost 1.5 percent over the 32-day period. As such, there is no evidence of a subsequent price decline following capital expenditure announcements.

Within the subcategories, expenditures for general capacity expansion and for capital budget increases were received most positively by investors.[24]

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[24] The positive returns associated with capital expenditure announcements, and especially the results for the capacity expansion subsample, provide evidence against the size maximization hypothesis, as discussed in Malatesta (1983) and footnote number 18.

FOR 260 ANNOUNCEMENTS OF LARGE CAPITAL SPENDING PROGRAMS, THE AVERAGE TWO-DAY, MARKET-ADJUSTED RETURN WAS 0.35 PERCENT. . IN ADDITION, THESE STOCKS OUTPERFORMED THE S&P 500 BY ALMOST 1.5 PERCENT OVER THE 32-DAY PERIOD.

	Dividends Per Share				
Long-Term Value Index** (LVI)	Current Dividend	Dividend Yield	Projected Dividend Growth	Pres Val Next 5 Yr Dividends	Long-Term Value Index** (LVI)
65.3%	$1.80	5.5%	6.0%	$7.98	75.6%
45.9%	$1.20	2.6%	7.0%	$5.36	88.2%
72.6%	$0.76	2.9%	11.0%	$3.74	85.6%
62.5%	$1.20	4.1%	5.0%	$5.23	82.2%
	NIL	NIL	NIL		
68.6%	$1.40	2.9%	9.5%	$6.84	85.7%
74.3%	$2.40	5.5%	2.5%	$9.66	77.9%
67.2%	$1.20	3.2%	5.5%	$5.25	86.2%
56.1%	$3.40	3.9%	7.0%	$15.30	82.4%
38.7%	$1.80	4.4%	7.0%	$8.26	80.0%
67.3%	$2.00	4.7%	6.5%	$9.12	78.4%
72.0%	$1.40	3.2%	11.0%	$7.07	83.9%
41.9%	$5.00	7.1%	9.0%	$24.00	65.7%
8.9%	$1.60	2.8%	4.0%	$6.61	88.6%
60.2%	$4.40	3.8%	11.0%	$22.38	80.7%
43.7%	$1.20	2.8%	9.0%	$5.66	86.9%
65.6%	$0.50	1.1%	13.0%	$2.67	94.4%
72.0%	$3.84	2.4%	20.0%	$24.94	84.7%
63.8%	$2.12	3.6	11.0%	$10.71	81.9%
	NIL	NIL	NIL		
44.7%	$3.60	3.9%	18.5%	$22.23	76.1%
31.6%	$1.60	5.5%	5.5%	$6.98	76.0%
71.6%	$2.80	3.4%	6.0%	$12.50	84.9%
36.7%	$2.00	5.5%	5.5%	$8.55	76.4%
	NIL	NIL	NIL		
	$1.20	3.7%	10.0%	$5.94	81.9%
	$1.50	6.3%	3.0%		
48.2%	$1.40	3.4%	8.5%	$6.58	83.8%
50.3%	$1.72	3.2%	13.0%	$9.01	83.1%
54.0%	$1.32	2.9%	14.0%	$7.20	84.0%
55.3%	$2.30	3.8%	9.1%	$9.99	82.1%

Summary of Findings

The consistently positive stock market reaction to announcements of various types of corporate strategic investment decisions provides significant support for the proposition that these announcements are interpreted by investors as managerial decisions with expected positive net present values. Thus, the results support the hypothesis that management is encouraged by market forces to make strategic investment decisions aimed at maximizing shareholder value.

The results offer no support for the propositions that (1) product and factor markets are so highly competitive that investment returns approximate the cost of capital and that (2) security prices reflect investors' expectations that managers will undertake profitable strategic investments aimed at providing for future growth and increases in shareholder value. In addition, and more important, these results contradict the popular notion that the markets are myopic, focusing on quarter-to-quarter earnings to the exclusion of considerations of long-term competitive growth.

THE FUNDAMENTAL VALUATION OF COMMON STOCKS

The positive reaction of stock prices to corporate strategic investment decisions suggests that the market looks well beyond the next quarter in setting security prices. Nonetheless, critics of the market claim that day-to-day security price fluctuations, generated to a large extent by the buying and selling of institutional investment managers pursuing short-term trading profits, do not reflect long-term corporate prospects. As noted by Alfred Rapport, however, "it's important to distinguish between the daily scurrying of investors and the forces that determine market prices."[25]

According to the fundamental valuation theory presented earlier, the current price of a security is equal to the present value of all future cash flows to investors. The discount rate, which reflects the risk of the security and the time value of money, represents investors' required rate of return. Using this model, and using both current dividends and accounting earnings as proxies for expected net cash flows (which should be reasonable, at least over a broad sample of firms), we can perform a little experiment to assess the investment time horizon of the stock market.

Table 3 provides recent and projected data for the Dow Jones Industrials. For each security, the data given include the stock price, the P/E ratio, current dividends and earnings, and Value Line Investment Survey's estimated beta and 5-year projected dividends' and earnings' growth rates. Using the Capital Asset Pricing Model (CAPM) to estimate investors' required rate of return, the present value of the next five years of dividends and earnings is computed.[26] Comparing each of these figures to the current stock price provides an estimate of the proportion of the current price which may be attributed to short-term (next five years) versus long-term (beyond five years) dividends and earnings. Those proportions of the current stock price attributable to dividends and earnings beyond 5 years I am calling the "Long-term Value Indices" ("LVI"s—"LVID" for dividends and "LVIE" for earnings).

With the Dow Jones Industrials valued at a P/E of 14, which approximates the historic range, the average LVID is about 80 percent and the average LVIE is 55 percent. As might be expected, companies with poorer growth prospects tend to have lower LVIs, and vice-versa.[27] Rappaport reported similar LVI results, which he summed up in the following manner:

In short, prices behave as if the market cares most about companies' long-term prospects, even though the financial community appears to emphasize short-term financial results. The most plausible explanation of this seeming paradox is that investors often see long-term implications in current information, including reported earnings, and use the latest results to reassess a company's prospects.

Overall, these results suggest that the market places considerable emphasis on a company's long-term prospects in valuing securities. As noted by Rappaport, high LVIs are an indication of the market's confidence in the ability of well-managed companies to gain and sustain a competitive advantage in the future.

CONCLUDING COMMENT

This study provides evidence that (1) common stock prices react positively to announcements of corporate strategic investment decisions and (2) the market appears to place considerable emphasis on prospective long-term developments in valuing securities. These results contradict the popular press accounts which blame the competitive decline and corporate restructuring of U.S. industry on a myopic stock market. They are in fact strong evidence for the opposing claim (widely held by financial economists) that the popular "short-term theory" is, as Boone Pickens says, "pure hokum."

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[25] See Alfred Rappaport, "Don't Sell Stock Market Horizons Short," *The Wall Street Journal*, (June 27, 1983), p. 22. In this article Rappaport discusses the results of a study which is similar in form to the analysis that follows.

[26] In applying the CAPM, the interest rate on five-year Treasury securities was employed as the risk-free rate of interest, and a market risk premium of 2.5% was assumed. The latter estimate was provided by a major investment banking firmern.

[27] In his broader-based study, Rappaport reports the lowest LVIs for public utilities and the highest LVIs for companies in the electronic components, medical instruments, retail drugs, radio-TV transmitting equipment, and electronic computers industries.

■ J. RANDALL WOOLRIDGE

is an Associate Professor of Finance, as well as the Goldman Sachs & Co. and Frank P. Smeal Endowed University Fellow in Business Administration, at Pennsylvania State University. This study was performed in conjunction with the Blankman Strategic Decision-Making Program. Professor Woolridge's research interests are in corporate finance, with an emphasis on the valuation consequences of corporate strategic and financial decisions.

PREPARED STATEMENT OF SENATOR DAVID PRYOR

Mr. Chairman, I would like to thank you for calling this hearing this afternoon on S. 1654, The Excessive Churning and Speculation Act, sponsored by Senators Kassebaum and Dole. The proposal raises some important questions about the management of pension plan assets and investments generally, and I welcome this opportunity to discuss them.

As we all know, pension plans are extremely important in our society. Private pensions are a growing source of income for our nation's elderly population, and private pensions will increase in importance in the coming years as the baby boom population ages. In addition, of course, private pensions play a very significant role in the nation's economy. With assets of over $1.8 trillion, the prudent investment of pension plan funds is vital to maintaining a healthy economy.

The authors of ERISA recognized the importance of managing pension assets wisely and wrote into ERISA a strong prudence standard. Since the enactment of ERISA nearly 16 years ago, financial markets and investment opportunities have increased dramatically, yet all the evidence I have seen suggests that the ERISA prudence standard has worked extremely However, the proposal by the Senators from Kansas, by singling out pension plans, strongly suggests that the prudence standard of ERISA is not working adequately and that pension plans in particular are engaging in excessive churning and speculation.

I hope this morning's hearings can clarify a number of basic questions that concern me about this bill. For example:

- —are pension plans more likely than other institutional investors to engage in short term trading, and if so, why?
- —would taxing short term gains of pension plans, as proposed in S. 1654, actually deter speculation?
- —if the objective of the bill is to encourage investment managers to take a longer term view, shouldn't all investors be subject to the tax, not just pension plans?

As Chairman of both the Select Committee on Aging and this committee's Subcommittee on Private Pensions, I am very concerned that we not single out pension plans for special taxation unless there is clear and convincing evidence of aberrant trading and investment activity. The taxation of pension plans could have serious adverse effects. Moreover, a tax on short term trading by pension plans adds yet another degree of complexity to the administration of pension plans.

The Subcommittee on Private Pensions is going to hold a hearing on this issue Friday morning because the current degree of complexity is becoming so critical as to threaten the long-term growth and viability of our nation's private pension system. The Kassebaum-Dole bill is one more example of a proposal that would add considerably to the cost and complexity of administering pension plans without apparent benefit to plan participants and beneficiaries or the nation's economy.

PREPARED STATEMENT OF MYRON S. SCHOLES

INTRODUCTION

Mr Chairman and members of the Committee, my name is Myron S. Scholes. I am the Frank E. Buck Professor of Finance at the Graduate School of Business, and a Senior Research Fellow at the Hoover Institution, Stanford University.[1] I am also a Research Associate of the National Bureau of Economic Research, and I am on leave as a Professor of Law, Stanford Law School. Before coming to Stanford in 1983, I was the Edward Eagle Brown Professor of Finance and Director of the Center for Research in Security Prices at the Graduate School of Business, University of Chicago. I have undertaken extensive research into the operations of the securities markets, and on the pricing of securities.

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[1] Since January, 1990, I have been on short-term leave from Stanford. I have been working with Salomon Brothers, Inc. in New York. The views expressed in this statement are strictly my own. I appreciate this opportunity to testify on the implications of imposing transaction taxes to dampen the short-term trading activities of investors in our securities markets. I am of the view that although taxes on portfolio turnover, either by pension funds specifically, or investors generally, will increase tax revenues, and will appear to provide incentives to invest for the long term, they will have unintended side effects that include a reduction in liquidity and market prices in securities markets, a decline in the flow of information into securities prices, and an increase in the cost of capital to corporations. I will address these issues in this statement.

COST OF CAPITAL OF US CORPORATIONS

In recent years, the higher cost of capitals of US corporations have reduced their investment horizons. The high real rates of interest in the 1980s, compared to the 1950–1980 time frame have increased capital costs. With increases in the cost of capital, the present value of long-dated cash flows falls. If these cash flows have little incremental value, the investment decisions of corporate managers will appear to be short-lived. We should applaud their decisions, however, for by investing short term they are preserving our scarce resources. Moreover, prior to the 1980s, we were net capital exporters of relatively less expensive capital, and our investment decisions were relatively longer than the countries to whom we exported capital. Currently, we import capital that must be invested for shorter horizons than in the originating home countries for the simple reason that it is more expensive to produce goods and services in an unfamiliar host country than at home. There are information differences to produce abroad that require greater returns. As we became an importer of capital, our cost of capital increased, and without attendant increases in future cash flows, investment horizons naturally became shorter.

The claim that Japanese managers currently take the long view might simply be a manifestation of the simple fact that they face lower capital costs than US managers. When US managers crank through the numbers they cannot justify making investments for as long a term, for if they did so, their shareholders would suffer through a fall in the market value of their shares.

Short-term trading might not affect investment horizons. The turnover rates of stocks traded in Japan are just as high as in the US. In the US, in 1985, 54% of the number of shares listed on the New York Stock Exchange changed hands. The percentage jumped to 64% in 1986, 73% in the crash-year, 1987, and then fell back to 56% in 1988. Turnover rates are up considerably from the early 1980s and late 1970s when turnover rates were as low as 21% a year. Some of this increased turnover, however, can be explained by the increase in the number of cash tender offers, and the growth of share repurchases and recapitalizations that started in the early 1980s and grew dramatically after 19. In Japan, where there has been a transaction tax on securities trading as high as .55% prior to April 1989 (now .3%), the turnover rates are even greater than in the US. In 1988, the turnover rate was 98%; in 1987, 96%; and in 1986, 75%.[2] Japan has been championed as a country with long-term investment horizons, and yet short-term trading activity is quite high in Japan. Moreover, although the Japanese transactions tax dampens share turnover rates, their turnover rates are still very high.

US TAX POLICY ENCOURAGES SHORT-TERM INVESTMENT

An important corporate goal is to invest in projects that increase shareholder value. Since 1986, US tax policy has increased the cost of capital to US corporations and reduced their investment horizons. The elimination of the exclusion of part of realized capital gains from taxation increased the shareholder-level tax rate Although the corporate tax rate was reduced, many tax benefits such as investment tax credits were eliminated, and depreciation lives were extended. The reduction in personal tax rates relative to corporate tax rates and the increase in the capital gains tax rate made producing in corporate form more expensive than operating in partnership or other forms that escape corporate taxation. Investors continue to remove assets from corporate solution. For example, a partnership operator faces a maximum tax rate of 28% on income, while corporate shareholders pay taxes of 34% at the corporate-level and then face additional tax at the personal level that could be as high as 20% per year on an annualized basis. This increase in taxation requires that investments generate higher before-tax rates of return at the corporate level to produce sufficient income to pay taxes at both the corporate and shareholder levels and to reward shareholders for undertaking these risks. Once again, distant cash flows are not as valuable at higher discount rates, and managers are forced to take projects with shorter investment horizons.

Foreign investors, however, have been encouraged to acquire US assets and invest in US companies for two reasons. First, US investments are now tax havens or shelters for them. The 34% US tax rate is below many foreign tax rates. Moreover, these investors face no US capital gains tax and may face no or a low foreign capital gains tax rates on the sale of their investments. Second, investors from such tax credit countries as Japan and the UK prefer foreign investments that are accompanied by few tax deductions for these investments require higher before-tax rates of return than investments with liberal tax deductions such as those with investment tax credits and liberal depreciation allowances. The 1986 Tax Act eliminated these tax shelters, and, as a result, increased required before-tax rates of return and encouraged foreign investors to buy US companies that previously benefited from these tax benefits. Foreign investors have invested heavily in the US after the 1986 Tax Act. They use US tax credits to reduce their foreign taxes paid, and defer repatriation of their US investment returns. They can take a longer investment view than US investors.

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[2] These data were extracted from the 1989 Fact Books of the Tokyo and New York Stock Exchanges.

US TAX POLICY ENCOURAGES DEBT AND NOT EQUITY FINANCING

To reduce the cost of capital to finance investments, US corporations attempt to mitigate the impact of the corporate-level tax by paying out before tax returns as interest and not dividends. US corporations can only use debt financing to eliminate the corporate-level tax on the competitive part of a project's return. They would not pay a rate of interest on their debt that exceeds market rates, unless the debtholders were also the owners, which is a unlikely event for most US corporations. Managers, who are owners, can pay themselves ample compensation to avoid the corporate-level tax. But, few managers are also owners. As a result, the gains to innovation in the US must be doubly-taxed. The double taxation of the gains to innovation reduces the demand for R&D projects in the US and shortens the lives of investments in corporate solution. A transactions tax can only increase the costs of innovation for it would require higher before-tax rates of return on investments.

Congress might benefit by considering the adoption of a transactions tax along with the planned future discussions of the integration of corporate-level and shareholder-level taxes. Elimination of the tax on corporate income, or a generous reduction of capital gains taxes will lead to an increase in the lives of US investment projects and bring back many foregone projects to US corporations.

A TRANSACTION TAX IS AN INCREASE IN THE CAPITAL GAINS TAX

Currently, individual investors pay tax on dividend income and realized capital gains. If capital gains realizations were proportional to the amount invested in a security, a transactions tax is functionally equivalent to a capital gains tax. Japan currently gives investors the option of paying either a 20% tax on realized capital gains or a tax of 1% on the value of the asset that is sold. (These taxes are in addition to the .3% transaction taxes incurred on the sale of securities.) Any increase in the tax on shares increases the cost of capital, and an increase in the cost of capital shortens investment horizons. If US policy is aimed at increasing long-term investments, and one way to achieve this goal is to reduce the capital gains tax, it seems ironic that a reduction in capital gains taxes and an increase in transactions taxes could actually lead to a tax increase and a reduction in investment horizons.

TAX-EXEMPT INVESTMENT MANAGERS DO HAVE LONG-RUN HORIZONS

Pension fund managers (and other tax-exempt managers of endowment funds, and insurance company investment pools (the so-called inside buildup)) trade frequently. Often complaints arise that these investment managers take too short a view and penalize corporations that produce inferior short-term results. They sell the securities of those corporations that realize poor earnings even if these poor earnings were the result of heavy R&D expenditures to bring on new projects. It is argued that corporate managers observe these price reductions and as a result shy away from long-term investments that would produce long-term results but require short-term performance shortfalls. Even if it were true and many pension fund managers did dump these securities, new investors (including many other pension funds) would step forward to buy them and bid up their prices. Obviously market participants expect that current investments would produce a shortfall in current earnings followed by increased profitability. It is only unexpected bad news that causes stock prices to fall. And if they do fall, most empirical work in the accounting and finance literature indicates that stock prices adjust permanently to these bad earnings announcements. Prices do not bounce back and this indicates that the new earnings numbers signaled a permanent shift in the firm's long-run prospects.

Tax-exempt managers invest for the long term. Many portfolios (maybe as great as 50% in market capitalization) are effectively invested in passive investments such as index funds which attempt only to mimic the returns on some index such as the Standard and POor's 500. These investors certainly invest for the long term. They do not trade on specific investment results of particular corporations.

Many pension funds use so-called asset allocation techniques. If managers feel that stocks as a group are overvalued relative to bonds, they sell stocks and move into bonds. This creates turnover, but has little to do with the horizons of corporate investment projects.

In addition, pension fund managers trade in securities to adjust their holdings of market sectors. For example, mangers might believe that it is prudent to reduce their concentration in savings and loan stocks or in bank stocks and increase their holdings of technology stocks. Or, they might want to buy small stocks or high dividend-yielding stocks. They sell and buy baskets or bundles of these securities to effect their changing policies. This too creates turnover, but is decoupled from a specific corporation's investment decision making.

Many investment managers use the futures and options markets to hedge their risks or to increase their returns by creating synthetic securities. By hedging they can concentrate their holdings in specific stocks or sectors, which they believe will increase in value, while reducing risks (i.e., market-wide risks that they cannot control). Futures and options markets arose to facilitate institutional trading of these securities and baskets of securities. The stock exchanges tend to facilitate trading for the smaller investor. These futures and option market trades create short-term trading volume that is decoupled from specific corporate investment decisions.

Although a transactions tax or a capital gains tax on short-term trading by pension funds will reduce turnover, it will not solve the long-run corporate-investment problem. If short-term trading of pension funds really created a problem for corporate managers, those who complain about it could easily solve the problem. Since corporate officers and boards of directors approve the managers that are selected to manage their pension funds, they could simply direct their own managers to invest for the long run, and not trade on short-term news events. Pension managers can easily follow this strategy and should follow it if they believe that short-term trading produces inferior results. Just as index funds invest for the longer term, these long-term programs can pick specific firms or industry groups and stick with them until the long-run results are realized. These corporate officials will retain their pension fund managers even in the face of poor results. In any case, the evidence suggests that corporations seldom change pension mangers because of poor short-term results over a limited period. Corporations can solve the problem caused by the turnover policies of their own pension managers, if one exists, without the assistance of tax policy.

Managers fear that they will be taken over if their results are poor and that pension funds foster the takeover process. This is a real threat, but most firms should be taken over. The empirical evidence suggests that their shareholders benefit. And, tax policy has already gone a long way to protect incumbent managers (e.g., ESOPs; loss of tax attributes on a change in control; and recapture taxes and capital gains taxes on the sale of assets). To impose an additional small transactions tax or a short-term trading tax on pension investments will add little incremental protection. Usually the premium paid in a tender offer is large enough to overcome such a small tax.

A TRANSACTION TAX REDUCES MARKET LIQUIDITY

A transaction tax will reduce liquidity in the market. Investors will trade less frequently on small moves in fundamental values. As a result, information will not be incorporated into securities prices as quickly. With increases in liquidity, investors are attracted to markets, and this in turn attracts other investors to the market. As a result of this increased order flow, market makers can reduce their spreads to carry inventory and the market is more efficient. If investors believe that they can sell their holdings quickly and with low bid-ask spreads they will be more willing to hold securities. They are attracted to liquid markets. A liquid securities market increases investor demand for securities and lowers the corporate cost of capital. To reduce liquidity through a transactions tax will increase corporate capital costs, reduce the number of market makers, reduce demand for trading and will hurt futures and options markets, which rely on more frequent trading to effect portfolio strategies.

A SMALL TRANSACTION TAX WILL REDUCE SHORT-TERM TRADING BUT AT A POTENTIAL COST TO INVESTORS

A transactions tax will only slow down short-term trading. The experience in Japan and other countries indicates that it does not stop short-term trading. Researchers have indicated that market participants are willing to pay a substantial premium for liquidity.[3] Security prices could fall on the imposition of a transactions tax. Reducing liquidity forces investors to seek alternative investments of similar returns. There are many other illustrations of the effects of the level of liquidity on securities prices. For example, letter stock that is restricted as to resale sells at a substantial discount from unrestricted stock; closed-end investment funds sell at a discount from liquidation value; so-called off-the-run bonds sell at a discount to well-traded-bonds of similar risk; and high-yield bonds have experienced substantial price drops as the high-yield bond market became less liquid.

DO NOT INCREASE MARKET FRICTIONS BUT REDUCE THE COST OF TRADING

Some believe that slowing down short-term trading will attract more investors to the market. It is argued that short-term traders create noisy prices and scare away potential long-run investors. There is too much trading by these so-called noise traders who like to gamble. It is claimed that a transactions tax will reduce their trading activity, and security prices will not be as noisy. The cost, however, is that the same transaction tax will catch investors who find it too expensive to trade but who do have information that should be incorporated into security prices. The markets will become less efficient and this too could cause investors to seek alternative investments.

Instead of increasing trading frictions, tax policy should be directed at increasing the supply of transaction services. For example, regulated investment companies might run afoul of the so-called short-short test and lose their RIC status if more than 30% of their gross income arises in a period of less than 3 months. As a result, most mutual funds restrict their trading activities. Mutual fund holders, however, suffer because their managers can not seek out higher returns. They forego the benefits derived from providing short-term trading services. If they could trade, they would reduce the effects of these noise traders on security prices.

A TRANSACTION TAX IS MORE EFFICIENT THAN A CAPITAL GAINS TAX ON PENSION FUNDS

When we had a short-term-long-term tax differential, investors were encouraged to use markets to convert short-term into long-term gains. This is inefficient. Pension fund mangers will follow similar strategies. Moreover, the imposition of a tax on pension fund investing will encourage savings in other forms.

CONCLUSION

Since other researchers like to quote the famous J. M. Keynes who likened the securities markets to a casino, and who would have liked to have imposed transaction taxes on investors to prevent them from trading, I too will reference his conclusions. He argued that liquidity was crucial to investors. And if we reduce liquidity in markets through transactions taxes, investors will invest in other securities that offer more liquidity. As a result, he concluded that it was best not to impose such transactions taxes on securities trading. I too come to the same conclusion.

PREPARED STATEMENT OF ANDREW C. SIGLER

Good afternoon. My name is Andrew Sigler and I am the Chairman and CEO of Champion International Corporation. Champion is a leading U.S. manufacturer of paper and wood products. I want to thank the Committee for inviting me here today to testify.

For some years now, I have been decrying the excesses of leveraged transactions, whether those transactions were hostile takeovers or management-led buyouts. It is my belief that the almighty drive for short-term gain is the most damaging trend operating in our economy today and is a crucial factor in our unpreparedness for the global economy of tomorrow.

In examining the causes of our short-sightedness, I find that both institutional investors and corporate management must bear significant responsibility for the investment practices that have led us to where we are today. First, there has been staggering growth in the amount of assets under the management of institutional investors. Almost 50 percent of all equities are held by institutions, with about half of that in the hands of pension funds.

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[3] See for example, Amihud and Mendelsohn, "Liquidity and Stock Returns" *Financial Analyst Journal* (May–June, 1986).

In observing the actions of these institutions, particularly pension funds, I have come to the conclusion that, despite their potential for providing corporate America with the long-term patient capital needed to invest for our future, pension funds have not always acted in the long-term best interests of their beneficiaries (who are the employees and retirees of corporate America) or of the economy as a whole.

The question of whether institutions engage in excessive churning and the actual numbers on the turnover rate of institutional investors will be debated endlessly. However, the trend is clear. New York Stock Exchange data indicate that the turnover rate of NYSE listed shares rose from 19 percent in 1955 to 55 percent in 1988 (with a high of 73 percent in 1987, the year of the crash). These figures may vastly understate turnover, however, because they do not include turnover in more volatile derivative instruments. Statistics on turnover can also be misleading because often they indicate only the net position at the end of the measured period, obscuring any trading that took place during the period. Thus, if a stock were sold and then repurchased during the measured period, no turnover would be recorded.

Perhaps more important to examine are the types of investments made by institutions and their actions in the takeover game. During the go-go period of the 80s, institutions were fueling the takeover wars by tendering their shares to receive the short-term gains offered by raiders, by providing the cash for deals through purchasing junk bonds and investing in leveraged buyout funds, and, finally, by casting their proxy votes against every defense that corporate management could devise to protect itself from destructive raids.

All of these actions have been justified in the name of holding corporate managers accountable, improving efficiency, and benefiting shareholders. But when we examine these rationales more closely, they do not hold up under scrutiny. There are alternative methods of changing corporate management that do not destroy the company and there are means of improving efficiency that do not lead to bankruptcy. As for acting in the best interests of the beneficiary of a pension fund (typically an employee of a large corporation like Champion) one has to examine the long-term as well as the short-term implications of investment strategies to make that determination.

Is that employee better off if the pension fund makes a quick buck in the short run by investing in highly leveraged transactions which can lead to bankruptcy later down the road? Or is the employee better off if their money manager engages in a long-term investment strategy which does not necessarily produce as spectacular results in the short term, but leads to overall growth in the economy by allowing corporations to invest in research and development or the plant and equipment needed to be globally competitive over the long haul? Too often, investment managers have chosen the former, claiming that the strictures of ERISA law require that choice.

Responsibility for short-sighted behavior does not rest solely with institutional investors, however—corporate managers are as much to blame as the actual money managers for this short-term investment perspective. Corporate managers have judged their pension fund investment managers solely on how well they performed in the last quarter or at most over the last year. We also did not oversee their proxy voting to determine if their votes were consistent with a long-term investment strategy. While some companies are changing, the desire for immediate performance is still strong; most corporate managers are still more concerned with the short-term performance of their pension funds than with the impact of their activities on the economy's future.

You have asked me to address today whether this short-term investment perspective affects the decision-making of corporate managers. I will answer by providing you with an anecdotal story about my own company which I do not believe is atypical. Champion is a paper and forest products company. We own or control six and one-half million acres of timberland, the natural resource which forms the basis of all our products. Trees are a unique asset in that they are, by their very nature, an extremely long-term investment. Champion is planting millions of trees today that will not mature or be ready for harvest for anywhere from twenty to fifty years. Now that is a long time, particularly in today's markets, to wait for a return on your investment. And the investment is significant. Hundreds of millions of dollars will be spent to maintain those trees over that time period.

Numerous Wall Street investment advisors have approached me with the suggestion that Champion should sell off its timberlands on the theory that these holdings are a drag on our stock price. They insist that if I would just spin off the trees in a partnership or some other sophisticated financial deal, Champion's stock would soar. That is a tempting prospect, particularly since much of my own personal wealth is tied up in Champion stock. However, I firmly believe that it would be a disastrously short-sighted move on my part. The trees are our future—without them, there will not be a forest products industry in this country fifty years from now. And while the new owners might assure me of their willingness to supply Champion with its fiber needs today, who is to say those new owners will not find real estate development or some other activity to be a more lucrative use of the land tomorrow?

I know from my colleagues that I am not alone in feeling the pressure to manage for the short-term, to take whatever steps are necessary to increase shareholder value today at the expense of more wise, long-term investments in our future. Voluntary recapitalizations, management-led buyouts, stock buybacks, etc. have all increased exponentially. But many of these activities have been engaged in as a defensive measure rather than because they represent the best use of a company's scarce capital. In many cases, the only logical conclusion is that such decisions represent a poor use of capital; although they benefit the shareholders in the short-term, the economic squeeze of overleveraging can only be harmful in the long-run.

The other question I have been asked to address today is whether I think the Kassebaum-Dole bill to impose an excise tax on the short-term gains of pension funds is a reasonable solution to the problems I have discussed. I assume I was invited to testify because I am one of only a few business people willing to speak up in favor of such an approach.

First, let me try and explain my colleagues' reluctance to endorse such a tax, even if they share my views about the problem. The growth in pension fund assets currently represents a huge untaxed resource in our economy and is a tempting target in Congress' never-ending drive for revenue. Any effort to tax pension funds (even a proposal such as this which is intended to change behavior, not raise revenue) will be viewed as the camel's nose under the tent, i.e., just the first step in a broader attempt to raise real revenue through the overall taxation of pension funds.

I certainly share my colleagues' concern about the taxation of pension funds. I believe corporate America has done a credible job in providing a private pension system for its employees, and any attempt to tax such a system would simply lead to fewer plans, fewer covered employees and, eventually, a much greater burden on pubic resources and programs.

Where I differ from my colleagues, however, is that I am willing to take the risk in this instance. The short-term investment perspective of institutions is having such a damaging impact on our economy that I am willing to try something drastic along the lines of the Kassebaum proposal. I recognize that the bill as drafted has certain limitations. First, it reaches only pension funds, singling them out for different treatment and that may not make sense. Second, there is a question as to whether the six month holding period which allows the fund to avoid the short-term tax is appropriate. Perhaps more study is needed to determine what level of tax and what time period actually changes behavior.

The important aspect of this bill, however, is that it represents a significant effort to deal with the problem of short-term thinking in investment strategies—and I believe its sponsors are to be commended for their actions. We know from previous experience that the tax code can be an effective tool in changing investment behavior. Investment activity as a result of changes in the capital gains rate is a perfect example.

We should not limit ourselves to the tax code, however in considering how to infuse more long-term thinking into our investment practices. Changes in ERISA may also be warranted. It should be made absolutely clear that long-term investment decisions based on the health of the overall economy are acceptable under the fiduciary standards which ERISA money managers must meet.

The introduction of Senator Kassebaum's bill and this hearing enable us to engage in a dialogue about these problems and try to devise solutions to them. And if the Kassebaum bill is not the perfect solution, then I want to work to improve it or devise an alternative to it, rather than simply point out all the defects and do nothing.

Thank you for the opportunity to appear before you today and I would be happy to answer any questions that you might have.

PREPARED STATEMENT OF ROBERT E. SHULTZ

This testimony is presented by the Committee on Investment of Employee Benefit Assets (CIEBA), which is a committee of the Financial Executives Institute (FEI). It addresses the proposed legislation to impose a tax on the short-term capital gains of pension funds.

FEI is a professional association of over 13,000 senior financial executives representing some 7,000 American corporations. CIEBA currently has 36 regular members and 120 advisory members, all of whom are corporate ERISA-governed benefit plan sponsors with collective assets that total more than $450 billion. The corporations represented in CIEBA cover a broad range of industry groups and asset sizes, and members manage their plan assets on behalf of some 8,500,000 plan participants.

Robert E. Shultz, testifying for CIEBA, was formerly a pension fund manager for AIR Nabisco, IBM, New York Telephone, and Western Electric. He is currently serving as a technical consultant to CIEBA, and as Co-Chairman of CIEBA's Working Group on Taxation.

As pension fiduciariesl CIEBA members are deeply concerned about the myriad of legislation that has been introduced in recent months that could have significant effects on the future of the private pension system—a system which in 1988 paid out $137 billion in retirement benefits, nearly equalling the $148 billion paid out by Social Security. By all measures, the private pension system has been a vital leg of the U.S. retirement income system, and we urge careful consideration of any measure that could have a harmful effect on it.

The proposed legislation under discussion today is apparently based on the following presumptions:

1. There is an undue short-term focus in the investment practices of institutional investors and especially pension funds.
2. The symptom of that focus is pressure on outside investment managers for short-term performance, which results in "excessive" turnover in common stock portfolios.
3. This turnover ("churning") makes it difficult or impossible for corporate managements to have a longer-term focus in managing their companies, especially if long-term strategic investments cause dips in short-term earnings results.

The tax on pension funds' short-term capital gains would allegedly reduce short-term institutional selling of stocks. Corporate managements would thereby be freed from having to focus on short-term earnings at the expense of longer-term strategic investment for the benefit of the company.

CIEBA feels that this proposed legislation is an inappropriate way to deal with a very complicated set of issues. We believe that there are significant flaws in this proposal and feel strongly that the facts need to be re-examined and re-evaluated.

First, short-term trading strategies are generally not being pursued by pension funds, who are the target of this bill. The only evidence being offered to support the contention that pension funds are short-term traders is anecdotal, and the only systematic study done to research the subject—CIEBA's—found just the opposite.

> The average tenure of investment managers who invest on behalf of CIEBA's member firms is almost 8 years. The average tenure of managers who have been terminated has been about 8 Years. and 50% or less of those have been terminated for poor performance. clearly, these managers are not being fired for short-term performance reasons.
>
> The average annual turnover rate for CIEBA members' equity portfolios is about 40%, which translates into an average holding period of about 2½ years. In addition, turnover rates have fallen since 1986.

Second, this proposal does not address the more plausible reasons for the short-term focus of U.S. corporate managements:

> *The threat of a takeover.* Absent such a threat, corporate managements would have no need to be concerned with short-term declines in their earnings and stock prices.
>
> *The relatively high cost of capital in the U.S.*, resulting from our high level of real interest rates. In any standard discounted cash flow analysis, a high cost of capital leads corporate managements to favor business investment projects that have more rapid payback periods. The longer the life of the investment, the greater the effect a high required return has on the decision of whether or not to make the investment.

Both of these issues clearly have a more direct effect on corporate planning horizons than pension funds—yet neither is addressed by the proposed legislation. In fact, a tax, by negatively impacting market liquidity, will only exacerbate the latter problem by creating a higher cost of capital.

The legislation as currently structured for common stock investments would not, as the turnover statistics imply, have a very deleterious effect on private pension funds today. However, there are some very important reasons why legislation of this nature should not be enacted.

1. Implications for the U.S. retirement system

First, accepting the premise that this proposal is not aimed at raising revenue, establishing the precedent of taxing pension trusts, for the first time ever, would open the door to other tax measures on pension funds for other purposes, such as revenue raising and directing funds to certain types of investments.

Second, the more direct reasons for corporate short-sightedness, as outlined above, would not be addressed. Takeovers would not be stopped, the cost of debt would not be improved, and the cost of equity could be worsened. When these problems are not resolved, the likely next step is to raise the rates or lengthen the timeframes, since it will have been established—regardless of fact—that taxing pension funds is the way to solve the shortsightedness problem.

The private pension system is a voluntary, well-functioning system that owes its success partly to tax incentives that were put in place for the quite worthy purpose of encouraging companies to pre-fund for their employee's retirement income. (It should be noted that that incentive is in the form of a tax deferment, not an exemption: pension benefits are taxed when received by the participant.) While the temptation to tax pension trusts has always been there—for example, during World War II and the Korean War, when some marginal tax rates were as high as 90% and taxes were applied to a wide range of products and services not now taxed —legislators have wisely refrained from putting this system in jeopardy. Yet Congress is considering such a move now, at a time when the importance of this system to the nation is at an all-time high, given an aging population and possible future Social Security problems. The results of any meaningful tax on pension funds could be dramatic: as pension benefits become more expensive to provide, corporations will supply less, especially in the defined benefit form. And this legislation is not an "invisible" tax: of the total $2.05 trillion in pension assets (as of third quarter 1989), only approximately 40% are private defined benefit assets. Fully 23% are defined contribution assets, on which a tax would impact the employees directly and unambiguously, and 30% are state and local retirement plan assets, on which a tax by the Federal Government raises fairly substantial legal questions. The remaining 7% are assets of multi-employer plans, where again the incidence of the tax falls upon the plan participants, not the employers.

2. Implications for the capital markets and global competitiveness

Another effect of the proposed legislation is that the capital markets and corporate capital-raising facilities would be weakened, not strengthened. We will have failed to improve the global competitiveness of either our corporations or our markets.

We do not agree with the legislation's implicit judgement that all short-term trading in the capital markets is undesirable, and we do not oppose short-term trading per se. Such trading promotes market liquidity, which contributes to a lower cost of capital for corporations; makes the market pricing mechanism more efficient, by allowing new information to be quickly reflected in stock prices; and, as many have argued, may actually reduce price volatility, by more quickly returning market prices (which do tend to fluctuate for a number of reasons) to fundamental valuations.

The principle function of the secondary markets is to provide liquidity and thereby minimize the cost of raising capital in the primary markets. Although capital is not raised in the secondary markets, their functioning has a direct impact on the cost of capital, because liquid secondary markets promote higher rather than lower stock prices, and therefore a lower cost of capital in the primary markets. If liquidity is impeded by the application of a tax—*whether a short-term capital gains tax, a transactions tax, or any other*—there can be no question that investors will demand a higher return, because they will be accepting a less liquid investment.

A meaningful tax on pension funds will also eventually result in increased contributions from corporate earnings. Increased costs for the same level of benefits, in the form of higher contributions from earnings, is in direct opposition to the efforts of all of us to improve our corporations' global competitiveness.

It is also instructive to examine the trends in other markets in the area of market taxation. In the European Economic Community, for example, the focus as 1992 approaches is to eliminate taxes, and in Australia, a recently-imposed tax caused trading and liquidity to decline significantly. Experiences and trends in other markets must logically be considered in decisions that will significantly affect the global competitiveness of our markets.

We also question the reason for the legislation's application of taxes to investments other than equities. Treasury bonds, bills, and corporate fixed income investments are impacted by yield curve shifts, duration, and other mathematical relationships that have nothing to do with the "loyalty" of the investor.

In sum, we are strongly opposed to this legislation. We recommend instead a systematic study of the roots of the problems—with basis in fact, not anecdotes—and an exploration of direct ways to deal with them.

CIEBA

Committee on Investment of Employee Benefit Assets

FINANCIAL EXECUTIVES INSTITUTE
COMMITTEE ON INVESTMENT OF EMPLOYEE BENEFIT ASSETS
SURVEY OF PENSION FUND INVESTMENT PRACTICES

The Committee on Investment of Employee Benefit Assets (CIEBA) of Financial Executives Institute (FEI) has conducted a survey on the investment practices of pension funds. The 36 funds represented by the Committee include many of the country's largest corporate pension funds, and exercise management responsibility for more than $250 billion in defined benefit assets.

The funds in the survey cover more than 8.5 million participants in over 300 separate defined benefit plans. Overall, as of September 30, 1989, the funds held 56% of their assets in common stocks (50% U.S. common/6% international), 33% in fixed income and the balance in real estate, venture capital and other assets.

The survey was designed to develop specific factual data on actual investment policies and practices of major pension funds. Participants were asked to supply data with respect to the turnover of their investment portfolios, and to report their use of index investment strategies (which tend to be associated with a longer-term "buy and hold" strategy). CIEBA members were also asked to respond to questions relating to the methods in which plan sponsors evaluate and manage the fund's outside investment managers. In each of these areas, primary emphasis was placed on data pertaining to the U.S. equity market; since the recent focus of pension fund investment practices has been on the effect institutional funds have on the equity markets.

Turnover

The survey data was collected during the fourth quarter of 1989; and data with respect to portfolio turnover was requested for the first nine months of 1989 as well as for the years 1988, 1987 and 1986. In order to ensure that a consistent definition of turnover was used, respondents were requested to calculate turnover consistent with the SEC definition for reporting the turnover by mutual funds. The equity turnover reported for each fund participating in the survey was averaged and weighted by the size of the funds U.S. common stock portfolios. For the period studied, the average turnover of the U.S. equity portfolios of the survey group was as follows:

% Turnover

U.S. Common Stock

Nine Months 1989	1988	1987	1986
33%	38%	51%	46%

Over the 21-month period from January 1, 1988 through September 30, 1989, the data shows an average annual rate of turnover of 40.8% considerably lower than the turnover rates reported in 1986 and 1987. For the periods 1986-88, the turnover rates represent an annual rate of turnover, but the nine-month 1989 figure is not annualized.

Where applicable, respondents were also asked to differentiate between the turnover rates in their passive, or market index equity portfolios, and in their portfolios managed in accordance with traditional active management strategies. The results are summarized below.

% Turnover

U.S. Common Stock
9 Months

	1989	1988	1987	1986
Passive Equity Portfolios	13	15	24	19
Active Equity Portfolios	47	48	66	56

As expected, the turnover on passive accounts was substantially lower, averaging about one-third the turnover rates of the actively managed accounts. It should be noted, however, that the overall averages mask some exceptions to the broad trend among individual funds. For example, few funds have had average turnover in their overall actively managed portfolios of less than 10%. The data clearly shows a declining trend in turnover rates over the periods for both active and passive portfolios.

Index Management

Data was also collected regarding the funds participation in the use of index investment strategies. Confirming trends reported in other studies, the responses show that over the past five years there has been a substantial increase in the use of market index investment strategies. Whereas in 1984, only 14 out of the 36 funds reported using index strategies for some portion of their U.S. equity assets, by 1989 27 out of the 36 were indexing some portion of their U.S. equities portfolio. For years prior to 1986, sufficient data was not available to determine the percentage of equity assets invested in index strategies. However, the data was available beginning in 1986 and indicates a modest increase from 30% of the U.S. common stocks being indexed in 1986 to 34% as of September 30, 1989. Given the smaller number of funds using index strategies in 1984 and 1985, it is reasonable to assume that had the data been available, it would have indicated that a much lower percentage of the overall group's common stock were assets indexed in these years.

Investment Manager Relationships

The survey funds management of outside managers did not support the assertion that pension plan sponsors evaluate their managers primarily on short-term performance. The nearly unanimous response to the question relating to the time horizon over which managers are typically evaluated was "a three-to five year period" or " a complete market cycle." Moreover the average tenure of managers currently employed by the surveyed funds is about 7.5 years. On average, about 8% of the survey group's managers are terminated in a given year, and those terminated have been employed as managers for the fund for 7-8 years prior to their termination. Year-by-year experience was as follows:

No. of Managers (beginning of period)		No. of Managers Terminated	%	Average Tenure Terminated Managers
1989	427	32	7.4	7.6 years
1988	410	29	7.0	8.0
1987	376	34	9.0	8.7

Data indicated that managers are not "hired and fired" based on short-term pressures from plan sponsors. In fact, the reasons given by sponsors for terminating investment managers were in addition to "poor performance" (1) A change in the fund's broad investment strategy; (2) changes in personnel; and (3) general decision to consolidate the number of managers.

PREPARED STATEMENT OF LAWRENCE SUMMERS

Mr. Chairman and members of this committee. My name is Lawrence Summers. I am a professor of economics at Harvard University and research associate of the National Bureau of Economic Research where I concentrate on issues relating to taxation and financial markets. I am very pleased to have this opportunity to address the issue of using the tax system to limit short term trading. I believe that this would be desirable, though my analysis suggests that proposals to raise the taxation of short term capital gains are misguided and would prove counterproductive relative to their objectives.

I have recently published a paper, jointly with Victoria Summers on the topic of transactions taxes, and have submitted it for the record. This testimony draws heavily on it. I will make three main points.

First, there are strong economic efficiency arguments for taxing short term trading. Taxes on short term trading would tend to discourage destabilizing speculation, excessive financial engineering, and excessive shareholder impatience. Any tax discourages some behavior. Discouraging short term trading is much more better than discouraging working or saving.

Second, securities transaction taxes are far preferable to increases in short term capital gains taxes as devices for curbing short term trading. Increases in short term capital gains taxes would probably reduce government revenues and would also actually encourage short term trading. The feasibility of securities transactions taxes is evidenced by the fact that they are in widespread use abroad, and by their current use on a small scale in the United States.

Third, the objections usually lodged against transaction tax proposals are weak. Securities transaction taxes would not drive financial markets overseas, would not make American capital markets dangerously illiquid, and would not have a significant adverse impact on equity values.

I. Economic Rationales for Taxing Short Term Trading

Technological and institutional innovations have radically transformed financial markets in the United States and around the world permitting and encouraging spectacular increases in the volume of trade in securities of all kinds. In all of 1960, 766 million shares were traded on the New York Stock Exchange, while in 1987 more than 900 million shares changed hands in the average week. More shares were traded on the lowest-volume day in 1987 than in any month in 1960. And more shares changed hands in the first 15 minutes of trading on October 19 and 20, 1987, than in any week in 1960.

In the narrow sense of permitting trade to take place between consenting adults, these statistics make it obvious that our financial markets have become much more efficient over time. Where unloading a million-dollar portfolio of stock might easily have cost $10,000 or more in 1960, today a functionally equivalent transaction can be carried out in the futures market for a couple of hundred dollars or less. Despite the tremendous increases in their transactions efficiency, the contribution of our financial markets in contributing to overall economic performance has been questioned with increasing frequency in recent years.

Even some active participants in the markets complain that the excessive pace of trade gives rise to excessive volatility. First Boston's Albert Wojnilower (1980) has expressed the fear that: "The freeing of financial markets to pursue their casino instincts heightens the odds of crises...Because unlike a casino, the financial markets are inextricably linked with the world outside, the real economy pays the price." Concern about the consequences of rapid turnover in financial markets is hardly new. In one of the most famous chapters of The General Theory, Keynes questioned the benefits of more liquid and smoothly functioning financial markets:

> "As the organization of investment markets improves, the risk of the predominance of speculation does increase. In one of the greatest investment markets in the world, namely New York, the influence of speculation is enormous. Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes the by-product of the activities of a casino, the job is likely to be ill-done. The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield cannot be claimed as one of the outstanding triumphs of laissez-faire capitalism-which is not surprising if I am right in thinking that the best brains of Wall Street have been in fact directed towards a different object."

He continues the same passage by suggesting a possible remedy for the problems caused by excessive speculation:

> "These tendencies are a scarcely avoidable outcome of our having successfully organized 'liquid' investment markets. It is usually agreed that casinos should in the public interest, be inaccessible and expensive. And perhaps the same is true of stock exchanges...The introduction of a substantial government transfer tax on all transactions might prove the most serviceable reform available, with a view to mitigating the predominance of speculation over enterprise in the United States."

Introduction of a securities transactions tax would be likely to improve economic efficiency in three respects. First, it might well reduce the incidence of destabilizing speculation.

In examining the relationship between speculation and volatility it is helpful to distinguish two types of speculative strategies. The first type which might be called "value investing" involves negative feedback. Traders who purchase stocks on the basis of comparisons of stock prices with some relatively stable estimate of fundamentals will normally find themselves selling when prices rise and buying when they fall thereby tending to reduce volatility. Negative feedback will also arise when traders rebalance their portfolios, buying and selling equity to hold a given fraction of their assets in the form of stocks, or when they operate on the basis of theories holding that the market overreacts to news. The second type of trading strategy involves positive feedback buying when markets rise and selling when they fall. Positive feedback traders tend to increase volatility. Those who believe that "the trend is your friend" pursue positive feedback strategies, as do those who place stop-loss orders, or use dynamic hedging strategies in an attempt to insure their portfolios.

In his discussion of the stock market in The General Theory, Keynes was at pains to stress that most investors did not focus on gauging long term fundamentals, but instead concentrated on assessing market psychology and the likely direction of short run movements in markets. He attributed this to the temperament of those likely to go into money management and to the way in which money managers are evaluated, stressing that those who are orthodox and wrong are often more richly rewarded than those who are unorthodox and right. The nature of negative feedback trading strategies is that there is no need to trade frequently—assets that are purchased are expected to earn abnormally high returns in a manner of months or years not days or weeks. On the other hand, frequent trading is the essence of positive feedback trading strategies. Think of investors who rely heavily on stop-loss orders, sell out when they get margin calls, or trade continuously as part of dynamic hedging portfolio insurance strategies. Any sort of curbs on short term speculative trading are therefore more likely to discourage positive feedback investing to a greater extent than negative feedback investing and may therefore reduce asset price volatility.

This argument may be more complex than is necessary to support the argument that increased liquidity leads to greater volatility. Even leaving aside the issue of positive vs. negative feedback trading strategies, measures that curb speculation may discourage investment by those whose information does not bear on fundamental values but instead represents judgments about the guesses of others. If they discourage such "noise trading" measures which curb speculation it will contribute to reductions in volatility and improve the functioning of speculative markets. Reductions in noise trading will cause prices to fluctuate less violently about fundamental values both because there will be less speculative pressure on prices and because speculative pressures will be more easily offset given reduced risks from changes in noise trader demands.

The dramatic run of stock prices in the first three quarters of 1987, as investors reinvested their market gains and relied on portfolio insurance to get them out of the market if it started to decline, followed by the October crash tends to highlight the potentially adverse consequences of an environment where speculation is too easy. Statistical studies inevitably find a positive relationship between turnover and volatility, though the direction of causation is far from clear. As we have already noted, turnover has increased very substantially because of declining transactions costs over the last several decades with no concomitant decrease and perhaps a trend increase in volatility. On balance, it appears that discouraging short term trading would not increase volatility and might well reduce it.

Perhaps the most frequent complaint about current trends in financial markets is that so much talented human capital is devoted to trading paper assets rather than actually creating wealth. The spectacle of one fourth of the Yale senior class applying for a job at First Boston generated more than a little comment to this effect. Excessive financial engineering effort provides a second rationale to taxing short term trading.

In many sectors where productivity increases have been far greater than in the overall economy, agriculture and manufacturing for example, the share of employment declined. However, the demand for financial services seems to be so elastic that, as Figure 1 demonstrates, the share of American employment that is in the securities industry has increased sharply over time. Despite sharp declines in commission rates and other trading costs, the total real transactions costs associated with securities trading have risen significantly in recent years, as Figure 2 indicates. Perhaps James Tobin (1984) is correct in his assessment that "the immense power of the computer is being harnessed to the paper economy not to do the same transactions more efficiently but to balloon the quantity and variety of financial exchanges."

It is striking to contemplate the costs of operating our financial system. What is primarily at stake is the allocation of capital among corporations. These corporations had a combined income of about $310.4 billion in 1987. The combined receipts of member firms on the New York Stock Exchange in that year was $53 billion. This figure takes no account of the costs borne by individuals and institutions in monitoring their portfolios, acquiring information about securities, or actually making investment decisions. Nor does it take any account of the costs corporations incur in seeking to attract investors in their securities. It is not uncommon for major CEOs to spend a week or more each quarter telling their corporate story to security analysts. If we assume that these latter costs are even half as great as direct payments to securities firms, it follows that the cost of operating our securities market was over $75 billion in 1987. This represented 24.2 percent of total corporate profits, and was only a little less than the $133.8 billion that the corporate sector paid in taxes during the same year.

Is this too much? When one considers that the lion's share of corporate investment is done out of retained earnings, it is hard not to agree with James Tobin's judgment that "What is clear is that very little of the work of the securities industry as gauged by the volume of market activity, has to do with the financing of real investment in any very direct way." It follows that there is a strong case for reducing the volume of resources flowing into trading activities. First, Tobin raises the consideration that "Every financial market absorbs private resources to operate and government resources to police. The country cannot afford all the markets that enthusiasts may dream up." It is true that many attempts to start financial markets fail just as many new casino games fail to catch on. But the fact that some markets fail to meet the private market test hardly establishes that all should be able to inflict the costs of regulation on the government.

There is however a more fundamental reason for being concerned about the diversion of human and capital resources into the trading of securities. While well functioning securities markets have the desirable by-products of sharing risks and allocating capital to high value uses, it is nonetheless true that speculative trading is a zero-sum game in terms of its direct effects. If I buy stock from you, because I have a good tip, or good information of my own, or even a particularly trenchant analysis of my own, and the stock subsequently rises sharply I have won a zero-sum game. My gain from trading is exactly matched by your loss. Individuals each gain from acquiring information and trading on it, but much of the gains come at the expense of others so the social gains are much less than the private ones.

To see the point clearly consider these questions: How does the social return to research directed at gauging track conditions at Churchill Downs compare with the social return to research directed at developing a better mousetrap? What about research directed at predicting Carl Icahn's next move, or anticipating GM's earnings announcement hours early, or finding patterns in past stock prices that help to predict future stock prices?

When I stand up at a football game, I see better. When everyone stands up at a game tall people see better and short people see less well than they did before, but overall the game cannot be viewed anymore clearly. The same is largely true when everyone seeks to gather information to guide their trading on the stock market. There is of course a potentially important difference between the stock market and the race track. There is no advantage to knowing about track conditions. On the other hand, if individuals gather information and trade on it, stock prices will reflect their information perhaps contributing to the efficient allocation of capital. This may well be an important beneficial effect of long term investments. It is hard to believe that investments made with a horizon of hours reveal much socially beneficial information to the market place.

A tax on short term trading is a natural policy for alleviating this market failure. While it would not have much impact on long term investors who invested on the basis of judgments about the true value of assets, it would have the significant impact of making it less attractive to invest in various short term prediction activities. By encouraging investment research directed at long term rather than short term prediction, it might help to solve the conflict noted by Keynes between the privately and socially most desirable investment strategies.

A third and final economic rationale for taxing short term trading is that it would cause shareholders to focus more on companies long term prospects. If transactions taxes drive irrational investors who do not look beyond quarterly earnings reports out of the market, companies may be more willing to accept reductions in quarterly earnings that reflect investments with long term payoffs. Firms may take a longer view when their stock price is less sensitive to current market conditions.

As Louis Lowenstein and other have argued, transaction taxes that tie shareholders to firms may induce shareholders to take a more active role in monitoring management and insuring that proper planning and investment activities take place. In Albert Hirschman's famous phrase, transactions taxes tend to substitute shareholder "voice" for shareholder "exit." With significant transactions costs, it is possible that dissatisfied shareholders would seek to influence or displace corporate managements rather than simply to buy other companies. The importance of this effect is open to question. Even for relatively large passive investors, the free rider problem is likely to discourage efforts to control managerial behavior.

Perhaps most importantly, lengthening portfolio holding periods by discouraging speculation might well induce investors to focus more on fundamental values—on confronting "the dark forces of ignorance" to use Keynes's phrase—rather than on gauging market psychology. To the extent this change in investment practices was conveyed to managers, they might pursue different strategies. Or, perhaps more plausibly, in the different environment that would result if speculation were reduced different types of managers would be selected to run major companies.

The three economic arguments here create some presumption that it would be desirable to curb short term speculation if this could be done without adverse side effects. The next section considers how tax changes could achieve this objective.

II. How to Tax Short Term Trading

There are two broad approaches to the problem of taxing short term trading. One is to raise the tax rate on capital gains generated by short term trading. The other is levy an excise tax on the transfer of certain assets, regardless of who the transaction is between. I believe that this latter approach offers far better prospects for discouraging short term trading than the capital gains tax approach which might well prove counter productive.

There are three important difficulties with proposals to get at excessive speculation by raising tax rates on short term capital gains. First, such taxes unless extended to taxpayers who are now tax exempt would not apply to most short term traders. While institutions account for under half of share ownership, they account for the lion's share of daily trading volumes. I am skeptical that the issue of short term trading is sufficiently important to warrant altering traditional conceptions of which types of institutions are tax free.

Second, there is what might be called the "fair bet" problem. If a short term capital gains tax were to operate in the standard fashion it would permit losses to be netted against gains in computing taxable income. In this case, the government is likely to encourage rather than discourage speculation. Consider an investor who is willing to buy 1000 shares of stock at a price of 50 because he thinks that there is a 2/3 chance that a company will be taken over and its price will go to 60 and a 1/3 chance that no takeover will take place and the stock will fall to 40. Such an investor is risking a $10,000 loss in return for what he perceives as the greater chance of a $10,000 gain. Now suppose that a 50% capital gains tax is imposed. Then if the investor continues to purchase 1000 shares, his risk and his expected return will be reduced. But if the investor increases his investment to 2000 shares, he will again have $10,000 at risk. The point here is simple—by becoming a silent partner in investments through the capital gains tax, the government encourages increased speculation because of the insurance it provides.

The fair bet problem could be avoided if the deductibility of capital losses were disallowed, even as an offset to capital gains. However, this would produce extremely high effective rates of taxation. Consider the example in the previous paragraph. Assuming he has judged the probabilities correctly, the investor has an expected profit of 2/3*10,000+1/3*-$10,000 or $3333. His expected tax liability would be 2/3*.5*10,000 or $3,333 so the effective tax rate on investment would be 100%. Admittedly, one-sided 50% taxes are not under consideration. But if as is more typical the investor was only 55% certain that the stock would go up rather than down, a 10% tax rate levied only on gains would translate into a nearly 40% effective rate. While I am sympathetic to the goal of curbing short term trading, a one sided tax on gains would be so punitive as to seriously dry up market liquidity.

Assuming then that losses can be offset against gains, there is finally what might be called the "straddle" problem with short term gains taxes. Past experience suggests that they have been consistent revenue losers. In 1984, for example short term capital loss deductions exceeded short term capital gains by several billion dollars. Investors would have an easy time avoiding short term capital gains taxes by purchasing assets that were likely to move in opposite directions, and then taking a short term loss on the one that went down, while holding the one that went up long term. In the process, short term trading would rise rather than fall. Index arbitrage is a classic example of the type of investment strategy that would be encouraged by a short term capital gains tax. It has proven almost impossible to write rules preventing individuals from doing this sort of thing. For institutions which have much lower transactions costs, and access to sophisticated advice, and an ever increasing range of securities, regulation would be impossible.

Fortunately, there is a better way to curb short term trading—levying a transactions tax. This is not a novel idea. The United States already levies a small fee on all stock transfers and the President's 1990 budget calls for increasing this fee. Most other major industrialized countries presently impose some form of STET. As Table 1 indicates, such taxes are in place in West Germany, France, Italy, the Netherlands, Sweden, Switzerland, the UK, and Japan among other places. These taxes collect a significant amount of revenue. In 1985, revenue collections ranged from .04% of GNP in Germany to .48% of GNP in Switzerland. This would correspond to a range from about $2 billion to $25 billion in the United States. Similar figures are suggested by the comparisons of STET revenues with total revenues and with the market value of outstanding equity.

A transactions tax of between .1 and .5 percent would have only a very small impact on investors purchasing stocks for a number of years. But it would add up very quickly for those who churned their portfolio. For this reason it would discourage short term speculative strategies. And it would avoid the difficulties inherent in a capital gains tax. Because it would be levied on the transfer of stock, it would not appear as a tax on what are now tax free institutions. Since trading itself would be taxed, there would be no chance of actually encouraging trading as a capital gains tax might. And since all share transfers would be taxed at a flat rate, it would be very simple to administer. Indeed, the apparatus is already in place.

III. Would Taxes on Short Term Trading Have Adverse Economic Effects?

There are as I have argued significant economic arguments for a tax on short term trading. Critics however suggest that such taxes might do serious damage to the American economy. Most of the criticisms boil down to three arguments. In considering these arguments it is important to keep in mind that the United States is one of the very few major industrialized countries that does not tax transactions.

First, critics argue that transactions taxes reduce market liquidity thereby discouraging investment and increasing the risks borne by investors. The basic answer to the liquidity argument is that beyond a certain point increased liquidity may start having costs which exceed its benefits. Furthermore even quite substantial transactions taxes would raise trading costs in the American market only back to their level in the 1950s, 1960s and early 1970s. Major liquidity problems were not evident at that time. By avoiding the illusion of liquidity, liquidity that is not there when all investors try to move in the same direction as in October 1987, transaction taxes may actually increase rather than decrease stability. At this late date, it is fair to throw the challenge back to the supporters of financial innovation. Trading opportunities have multiplied enormously in recent years. Whose risks have been reduced relative to what there were ten years ago? Whose access to capital has been augmented?

Second, critics assert that transactions taxes would drive trading overseas and so hurt the American financial industry. Any argument that we now devote excessive resources to financial engineering must recognize the corollary that it would be desirable to take steps that would make participation in the financial industry less attractive. However, fears regarding a drastic reduction in the size of the U.S. securities industry are unwarranted. As the significant revenue collections realized by most other countries from STET's attest, the tax can be sufficiently broadly drawn to avoid most such distortionary movements of trades involving U.S. interests and residents, particularly in the case of institutional investors.

International considerations can be dealt with in several ways. First, any transfer on behalf of U.S. person or institution may be made liable to the transfer tax. This is what happens with capital gains now. One cannot avoid capital gains tax liability simply by trading offshore. The same principle could be adopted in the case of a transactions tax. Second, any transfer recorded on a register kept in the U.S. (whether the principal register or a duplicate) would be subject to the charge. The British experience indicates that in the case of actual registered transfers of stock in operating British corporations, most companies would not move all of their books outside the country. Third, the transfer of beneficial interests by non-U.S. brokers, agents or clearance services without transfer of registration of legal title to the actual assets could be handled in a manner similar to that used in the British SDRT. A one-time toll charge at a rate significantly higher than that imposed upon the transfer of securities could be imposed upon a transfer of securities to a depository, fund or clearing agent outside the United States.

A third concern, that transactions taxes like any tax on investment income would discourage investment and saving is a legitimate one. A first response is that transactions taxes could be matched by reductions in other taxes on corporate income so that the total tax burden on investment income was not altered. Even if this were not done, a modest transaction tax would not have a major impact on the return to the long term investors who are the primary suppliers of capital even if they are not the primary traders in financial markets. A tax of .5 percent on the purchase or sale of stock is not likely to stop an investor with a horizon of several years from investing in the stock market. If a transactions tax which discouraged churning by institutions succeeded to only a small extent in restoring the confidence of small investors in the stock market, it would have a very favorable impact on national saving and investment.

IV. Conclusion

This analysis suggests that some form of speculation curbing STET would have desirable economic effects and would could raise a significant amount of revenue. The STET's revenue potential would depend on just how it was administered. But a conservative estimate based on a .5% rate, and only a small allowance for revenues collected from assets other than stocks would suggest that $10 billion a year could be raised.

In considering the STET as a revenue source, it is important to recall that while the STET is argued to improve economic efficiency most other tax measures are universally agreed to have adverse effects on incentives to work and save. Even if a STET has no beneficial effects on the economy, it is an efficient tax relative to most alternatives. Furthermore, since its ultimate incidence would be on holders of corporate stock, it would be highly progressive as well. More than half the stock held by individuals is held by those in the top one percent of the wealth distribution.

COMMUNICATIONS

STATEMENT OF THE AMERICAN ACADEMY OF ACTUARIES

The American Academy of Actuaries is the organization designated by the actuarial profession to represent its views on public issues in the United States. The Academy's 25-member Committee on Pensions is made up of representatives from all areas of pension practice. The Committee includes actuaries who work with small as well as large plans, defined benefit plans and all types of defined contribution plans, union and nonunion plans, single-employer and multiemployer plans, and public as well as private plans. The committee speaks on behalf of more than 3500 of the 4150 professional actuaries that are enrolled to practice under the Employee Retirement Income Security Act of 1974 (ERISA). These actuaries are involved in all aspects of pension plan design and financing, including the estimation of plan liabilities and the appropriate investment of pension plan portfolios. As in other professions, individual actuaries may take exception to the positions adopted by the Committee on Pensions.

INTRODUCTION

The basic thrust of pension plan investing has been little changed over the past 30 years. It has evolved, but there has been a remarkable degree of legislative continuity. Pension funds have prospered in this stability, and total pension assets are now measured in the trillions of dollars, enhancing the retirement security of tens of millions of Americans.

We believe that Senate Bill 1654 is a threat to this stability and a danger to the benefit security of all Americans in voluntary pension plans. We agree with the goals of the legislation: to discourage short-term speculation, to encourage a long-term investment horizon by pension funds, and to ultimately enhance the productivity and international competitiveness of U.S. businesses. However, we believe that S.1654 would not advance these objectives, and would instead have harmful and unintended results.

In this statement, we address policy issues, technical issues, and administrative issues. For your convenience, our statement begins with a summary of our principal conclusions.

I. SUMMARY OF PRINCIPAL CONCLUSIONS

1. Most short-term trading by pension funds is not speculative. For example, consider the monthly rebalancing of index funds. The purchase of an index fund is a long-term commitment to invest in America.

2. The excise tax would result in lower benefits for participants. This is particularly true in defined contribution plans, where the tax would be paid out of participant accounts.

3. Investment managers and plan sponsors would probably shift into more conservative equities, and out of growth or high beta stocks, to choose investments they were more comfortable holding. There would probably be a shift away from stocks towards bonds.

4. If the Bill should pass, it needs to be more complete, and leave less discretion to regulations to "carry out the purposes" of the legislation.

5. As drafted, the exception for funds with assets under $1,000,000 would not apply to public funds or defined contribution plans.

6. Fixed income or short maturity securities should be exempt from the Bill.

7. The effective date does not allow enough time for recordkeeping changes.

8. The Bill lacks accounting rules to determine which block of a stock was sold (FIFO? LIFO?). Is accounting at the plan sponsor or the investment manager level?

9. The Academy's Committee on Pensions opposes this legislation as harmful to plan participants, as punishing long-term investors, and as counterproductive to its stated goal of promoting long-term equity investment.

II. POLICY ISSUES

1. Reasons for Short Term Trading

One of the stated purposes of S.1654 is to discourage short-term speculation on the theory that corporations are inhibited from making long-term capital commitments because of the negative reactions of a short-sighted market.

In this view, a curb on speculative activity would allow corporations a freer hand to conduct the research (or commit the resources) necessary to make technological advances.

The Bill as written, however, targets all short-term trading and is not limited to speculation. There is a difference. There are a number of reasons a pension fund might engage in short-term trading that have nothing to do with either speculation or any corporation's time horizon. Examples are as follows:

(a) Index Funds: A large portion of equity investments are in index funds, tailored to duplicate the performance of a cross-section of stocks (e.g., the S&P 500). These plan sponsors have made a broad commitment to corporate America. There is not a longer-term strategy available. However, these funds are rebalanced monthly to reflect changes in the passive index. These rebalancings would be subject to the tax, penalizing a long-term perspective.

(b) Allocation by Asset Class: Many pension funds have written investment policies describing the relative proportions of trust assets to be invested in stocks, bonds, real estate, money market instruments, etc. For example, a fund's policy might be 60% to 75% invested in stocks, 20% to 35% in bonds, and 5% in the money market. These are long-term strategic objectives. Yet the tax would apply to asset class reweightings. If stocks were sold, either to stay inside prescribed limits or in response to a change in the long-term allocation (e.g., add real estate to the fund or another long-term investment with a 10% weighting), the tax would still be applicable.

(c) Investment Manager Restructuring: Managers may be terminated for a number of reasons: poor performance, a change in the broad investment philosophy of either the manager or the plan sponsor, a change in personnel at the manager, or a general decision to consolidate the number of managers. (Termination for performance rarely occurs after only a limited number of quarters.) Once again, changes due to long-term considerations can result in short-term trading, and a tax.

(d) Market Sectors: Just as pension funds have long-term objectives regarding the percentage of a fund to be invested in stocks, bonds, etc., there are often analogous objectives on the allocation among market segments (i.e., how much in technology stocks, how much in utilities, etc.). These broad objectives would also lead to rebalancing from time to time.

(e) Fixed Income: Bonds and mortgages might be bought or sold to maintain a desired duration or in reaction to shifts in yield curves. Short duration bonds or bills might be sold simply to generate the necessary cash to make benefit payments to pensioners. Neither type of trading is speculative or related to a corporation's planning horizon.

Some short-term trading is unavoidable for the above reasons, and often does not involve any speculation at all. Such trading would continue if S.1654 was passed. Plan assets would probably be used to pay the tax, which would result in lower participant benefits or higher employer contributions. In the case of defined contribution plans, it is difficult to think that plan sponsors would increase their deposits into individual accounts just to offset the effect of the tax. The participants would suffer.

In relation to these trading activities, the proposed tax would not serve to curb speculation. Nor would it promote a change in sponsor behavior. Rather, the tax would simply raise revenue from long-term investors...and harm the financial security of plan participants.

2. The Plan Sponsor Reaction

If S.1654 became law, how would plan sponsors adjust? We believe the least likely answer is that they would simply hold the same securities longer. Only slightly less likely, in our view, is the possibility that their behavior would not change at all.

Plan sponsors and investment managers make their selections after exhaustive analysis of the balance between expected investment return and investment risk. The proposed excise tax would penalize the net returns on more volatile stocks. The balance between risk and return would be disrupted by the excise tax, and would be reestablished at lower stock prices. In other words, prices would fall until the expected investment return was once more in balance with the risk. Investment would be drained away from growth stocks and from high beta stocks, and the cost of capital would become higher for these companies.

In short, it is unlikely that plan sponsors would simply hold the same stocks longer. Instead, they would switch to different stocks that weren't as risky.

Applying similar reasoning, plan sponsors would hold fewer stocks and more bonds. Stocks are more volatile than bonds. It seems less risky to extend the holding period on bonds. After considering the excise tax in the balance between expected return and investment risk, the asset class allocation would be altered, to the detriment of stocks.

These likely effects of the Bill would subvert the goals of the Bill: to promote the productivity and international competitiveness of America. A law that gives plan sponsors an incentive to avoid growth stocks, in particular, and all stocks, in general, does not advance the nation's commitment to corporate R&D.

Pension funds are not short-term investors. Pension funds commit a minimal percentage of their assets to LBO funds or junk bond funds, as indicated by many surveys. The only recent large-scale pension fund commitment to a strategy that might be labelled speculative was to portfolio insurance. Even there, the plan sponsor goal was a long-term goal, to safely increase the percentage of plan assets in stocks. As has been noted elsewhere, the market taught the portfolio insurers a lesson, and assets committed to that approach are now a small fraction of the levels of a few years ago.

III. TECHNICAL ISSUES

1. Completeness of Bill: The particular Bill under consideration lacks specifics. For example, the Bill contains an exception for transactions whose primary purpose is to reduce the risk of price or currency fluctuations. However, "risk" is undefined and the amount of risk reduction to obtain the exception is not quantified. What hedges are exceptions? As another example, the treatment of bank or insurance company pooled funds is unclear; are they "pass-thru entities"?

   In benefit matters, the IRS has recently issued a number of 100 page regulations regarding handfuls of sentences in the law. We are still waiting for benefit regulations that were mandated to be complete by February, 1988. Bills that leave the details for later, through regulations to "carry out the purposes" of the legislation, seem to be passing the buck. Benefits legislation should be more complete.

2. Exceptions for Under $1,000,000: S.1654 contains an exception for plans with assets under $1,000,000, as determined by section 412(c)(2). This section does not apply to defined contribution or public plans. We would suggest the reference be changed to be inclusive of these plans as well.

3. Offsets for Short-term Capital Losses: S.1654 does not make an offset available to a plan for losses that occur in the same time frame as taxable short-term gains. This is at odds with all prior capital gains taxation, and is even more restrictive than the current treatment of gambling gains and losses. Of course, an offset for short-term capital losses would encourage further short-term trading.

4. Fixed Income Securities: The stated goals of the Bill are to encourage long-term investing, fostering R&D that results in improved international competitiveness and productivity gains. These goals seem to relate to equity investments. Even if the reasoning behind the Bill is valid, it does not relate to the purchase and sale of fixed income securities. Accordingly, the Bill should not apply to non-equity investments.

5. Short Maturity Securities: The trading of securities that mature in less than one year cannot affect the country's long-term competitiveness. We suggest that short-term maturities be exempted from the Bill.

6. Taxation of Government Plans: The taxation of government pension plan assets would be even more of a departure from prior precedent than for private plans.

7. Effective Date: The time required for plan sponsors to adjust administrative systems and for the IRS to develop and issue regulations is of critical importance when there are major changes in the law. This reality should not be ignored, since the benefits of millions of workers are at stake. Particularly when a Bill is vague, it is unfair to force plan sponsors to operate in an environment where it is impossible to ascertain compliance with the law. The effective date should be one year after the issuance of final regulations. The effective date currently in S.1654 is not practical.

IV. ADMINISTRATIVE ISSUES

It is self-evident that S.1654 would result in additional recordkeeping. Taxable and non-taxable transactions would have to be tracked separately. Potentially taxable transactions would have to be maintained on a database that compared the sales price to the original cost. This is an extra requirement for many funds, who up to now may have only needed to track changes from the prior year-end market value. Systems would need to be enhanced, and time would be needed to do this.

There are other complications. For pooled funds that include excise-taxable and non-taxable investors, dual recordkeeping would be necessary. Investments made in the last 180 days of one year might be taxable in the next, so records would need to be maintained across years.

All these issues could be solved at some expense and after some time, but there is one significant issue not addressed by the Bill. Large pension funds generally have many managers, some of whom have duplicate holdings of the same stocks. How are sales to be accounted for: on a first-in-first-out basis or on a last-in-first-out basis? Which shares were sold? Is the accounting at the level of the plan sponsor or at the investment manager level? If the accounting is at the plan sponsor level, it is complicated, and new systems must be developed from scratch, probably by the custodian or trustee. On the other hand, accounting at the investment manager level would be unfair, since it could result in a tax if one manager sold 1000 shares while another manager simultaneously purchased 2000 shares.

V. CONCLUSION

We applaud the Committee for holding its hearings. Too often in the recent past, benefits legislation has been appended to budget reconciliation legislation without notice or discussion. An open airing of the ideas of various members of the public should lead to wiser legislation.

In conclusion, we would like to restate our considered opinion that pension funds are long-term investors. We oppose this legislation, not because pension funds are speculators, but because the Bill does not target speculation. S.1654 would punish long-term investors who must conduct some short term trades, and it would harm plan participants. It would give plan sponsors an incentive to adopt a more conservative investment policy, and it would drain capital from the stock market in general, and growth stocks in particular. These are exactly the types of companies in which the Bill's sponsors want to encourage long-term investment, but the result would be otherwise, to raise their cost of capital.

This legislation would not accomplish its stated goals, but it would raise revenue. As a result, professionals in the voluntary private pension system are wary that S.1654 would only be the beginning of a new and detrimental trend. Federal-directed social or economic planning with pension fund assets would be much easier once tax policy differentiations were imposed on pension funds, and the healthy period of legislative stability might end.

As stated in the Introduction, we agree with the goals of the legislation and with fostering the international competitiveness of our country. We would be pleased to assist in any way we can to develop proposals that address these goals.

STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE

The American Council of Life Insurance appreciates this opportunity to present the views of the life insurance business on short-term trading proposals. The Council is the major trade association of the life insurance business. The Council has a membership of 616 life insurance companies, which, in the aggregate, have approximately 94 percent of the life insurance in force in the United States and hold approximately 99 percent of the reserves for insured pension plans.

INTRODUCTION AND SUMMARY

The ACLI is opposed to any legislation that will tax pension funds. In particular, we are concerned that S.1654 (the Excessive Churning and Speculation Act), a bill introduced by Senators Kassebaum and Dole, which would impose an excise tax on the short-term gains realized by pension funds having over $1 million in assets, will adversely impact the private pension system. The bill is apparently based on the assumptions that short-term "churning" is extensive, that this turnover creates problems for corporate managers in taking a long-term view of their companies' profitability and that pension funds are the major cause of the problem. In addition, the bill's sponsors view pension plan short-term trading as promoting corporate takeover activity, which they also consider to be a problem. The tax on short-term profits would allegedly solve these problems by reducing short-term trading.

The ACLI does not believe turnover is excessive or that turnover is necessarily a problem. In addition, we do not believe that the imposition of a short-term trading tax on pension plans will promote U.S. competitiveness or reduce corporate takeover activity, the two stated goals of the bill. We do believe, however, as explained more fully in our testimony, that the proposed tax on short-term gains of pension plans will adversely impact plan participants, retard the growth of United States savings and increase the cost of pension plan administration.

There are no valid policy reasons for the proposed tax on short-term gains of pension plans:

- A tax on short-term capital gains of pension plans would (1) increase plan costs and/or reduce plan benefits and (2) retard the growth of U.S. domestic savings (at a time when such saving is far less than other industrialized nations).

- Any tax on pension funds is fundamentally unfair because it will result in double taxation. Amounts held pursuant to a qualified plan are tax-deferred, not tax-exempt, and are taxed when distributed. The threat of double taxation will discourage employers from establishing and maintaining plans.

- The proposed tax on pension funds will undermine Congress' fundamental promise to employers that contributions to a retirement plan will accumulate free of taxes until distributed to retirees. Employers have always been able to rely on this key tax incentive, even though a great many of the rules and regulations governing qualified plans have been radically altered in the past eight years. When employers learn that they cannot even rely upon Congress' promise to defer taxes, they will be even further discouraged from establishing and maintaining plans.

- The administrative costs to identify, calculate and report short-term capital gains for each separate pension plan is clearly a significant real cost that would ultimately be borne by plan participants.

- ERISA requires plan sponsors and plan fiduciaries to act in the best interests of plan participants. Plan participants should not be penalized (i.e., excise tax) when plan investment managers make investment decisions (buy/sell) that conform to maximizing performance requirements for the plan.

- There is no supportable evidence that high portfolio turnover of pension assets impairs capital formation, nor is there reason to believe a priori that high turnover implies greater market volatility.

SPECIFIC COMMENTS

The tax will adversely affect qualified plans.

An excise tax on private pension short-term capital gains would be ill-advised public policy. By diluting one of the major tax incentives for private pensions, it would inevitably weaken the existing private pension system and discourage individual saving for retirement in employer-sponsored arrangements. It would create further disincentives for employers to augment or continue plans at a time when the number of retirees is projected to be growing faster and when the share of the private wage and salary work force participating in pension plans has declined.

In the 1980s many factors have tended to limit the growth in participation and coverage under pension plans. Work force cutbacks by large firms with very good plans and a rapidly growing share of employees in small service sector firms have been among these factors. In addition to these trends, a web of disincentives in terms of increasing federal legislative and regulatory initiatives has been imposed on private pension plans since ERISA was enacted. Altogether, these have significantly raised the burden (both in terms of direct expenses and administrative complexity) of establishing, maintaining, and improving benefits in qualified pension plans.

Frequent changes in pension policy (nine major changes in the last eight years) have disrupted retirement planning by employers and individuals, raised the costs of plan sponsorship, and reduced benefit security. Congress has made it more burdensome for employers to establish and maintain plans. The proposal to put an excise tax on qualified plan short-term capital gains would impose further impediments on private pension plan development.

Future demands for benefits upon the private pension system will increase even faster than the rapid pace set in recent years as the "graying of America" continues over the next two decades. The population segment age 65 and older has been increasing at a much faster rate than the remaining population. By 2030, 21 percent of all Americans are expected to be 65 or older, compared with only 11 percent in 1980, a percentage increase of almost 100 percent. Congress should, therefore, currently encourage increased pension plan formation and improvement, and should not enact legislation which would discourage the formation of new plans and improvement of existing plans.

The tax could adversely affect capital formation by retarding the growth of domestic savings.

A tax on short-term capital gains of pension fund securities investments would retard the growth of U.S. domestic saving generally. At a time when net national saving is near a record low, it would be unwise to discourage private sector saving growth.

Capital formation (net investment in new plant, equipment, inventories, and residential construction) is a necessary requirement for GNP expansion. To generate net investment spending, an equivalent amount of net national saving (or foreign saving) is required. Since the availability of a sufficient inflow of foreign saving over time at reasonable cost is uncertain, it becomes even more important that the United States be able to rely on domestic net national saving. Servicing foreign debt imposes an additional burden on the present and future generations of U.S. citizens.

From 1952 through 1980, net national saving in the United States averaged over 7 percent of GNP and was sufficient to fully fund net private domestic investment. By 1988, net national saving was down to 2.6 percent of GNP, while net private domestic investment was 5.0 percent. The U.S. was not saving nearly enough to finance its capital growth. Thus, nearly half of domestic private investment in 1988 (an amount equal to 2.4 percent of GNP) had to be financed by foreign savers. This will become more of a problem as the real interest rate on foreign saving to finance our domestic investment will likely rise in coming years as capital requirements in Asia and Europe increase.

The U.S. net national saving rate in 1988 of 2.6 percent compares with 17.3 in Japan and 8.5 percent in West Germany.[1/] Work by economists G. N. Hatsopoulos, P. R. Krugman and Lawrence Summers shows that productivity growth and net national saving are directly related. Their work shows the U.S. to be well behind Japan, France and West Germany in productivity growth and saving.[2/]

In addition to the financial support they provide to retirees, private pensions directly undergird national saving, thereby playing a vital role in capital formation. Private pension assets account for a large and growing share of personal saving and the increase in personal net worth. From 1985 through 1988, the average annual increase in private pension assets was $105 billion. By way of comparison, total individual financial assets and tangible assets increased by $668 billion annually. But at the same time, total individual liabilities increased by $400 billion. Since pension asset growth does not generate debt (as the growth in other types of individual assets tend to do) pension assets can be considered the largest sectoral component of the $268 billion annual rise in net individual assets.

The administrative and other costs of an excise tax on short-term capital gains of pension plans will diminish the assets available to provide retirement benefits.

Federal rules and regulations issued since the passage of ERISA have resulted in increased administrative complexity for

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[1/] Lawrence Summers, "Stimulating American Personal Saving," Paper delivered at ACCF Conference on Saving, Washington, D.C., October 12, 1989.

[2/] George Hatsopoulos, Paul Krugman and Lawrence Summers, "U.S. Competitiveness: Beyond the Trade Deficit," Science July 15, 1988.

pension plans, which has resulted in higher costs for plan sponsors to maintain such plans. Such costs would be further increased by the proposed tax on pension funds, since procedures to identify, to calculate and to report short- term capital gains for each pension plan will have to be developed and implemented. Inevitably, these added costs will be borne by plan participants in the form of reduced assets available for the payment of pension plan benefits.

Many pension plans invest in commingled investment accounts or mutual funds. Every short-term capital gain identified must be allocated on some formula basis at the time each gain is recognized, since any one pension plan's share in the total account or fund can vary daily.

For defined contribution plans, there are particular problems centered on who bears the tax burden - the investment manager, the plan or the participant? This problem would be particularly acute in the individual account plan situation where the individual participant directs his account's investments. Will the participant bear the tax if he directs certain purchases and sales within the prohibited time period? S.1654 appears to apply the tax at the plan level, so that stock purchases and sales directed by individual participants are felt by all participants. If this is the result, it would seem to be inequitable, as plan participants who did not sell short-term would be penalized as the result of the actions of others.

In addition, even participants in defined benefit plans could be hurt by the tax. One of ERISA's fundamental objectives is to assure participants that defined benefit plans will be adequately funded to provide their promised retirement benefits. Insofar as the proposed tax will add to plan administration costs, directly diminish plan assets, or cause investment managers to forego lucrative investments, the tax will adversely affect the funding of defined benefit plans. This will, accordingly, impair the ability of defined benefit plans to provide promised benefits to participants.

A tax is not needed to discourage excessive turnover by pension fund managers because turnover by such managers is lower than generally thought.

There are nearly 900 investment advisers who file turnover data with the SEC (#13F filings). These advisers compete with each other for investment performance in pension management (and other activities).[3/] Each manager employs a variety of investment strategies to achieve optimal results. According to a study prepared for Congress by Dr. Carolyn Brancato of Columbia University, the annual portfolio turnover rate of these advisers ranged from 400 percent to less than 1 percent in the year ended in mid-1989. Only 13.6 percent of the advisers exceeded a 100 percent turnover rate and almost one-half of the total (47 percent) had turnover of under 40 percent. As Dr. Brancato concluded, clearly "institutional investors are not a monolithic group."

[3/] "Institutional Investors and Corporate America," Prepared at the Request of the Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, U.S. Senate, Oct. 3, 1989.

These data illustrate that widely varying turnover rates (of portfolios and of specific stocks) are a vital part of the competition for assets to manage. High turnover rates entail higher costs than do stable portfolios. The market itself contains a mechanism for curbing turnover--trade-offs among added risk, added revenue and added cost. This mechanism is the only nondiscriminatory device by which pension funds can reasonably position themselves competitively with respect to the length of any of their holdings. If the higher costs of higher turnover for particular portfolios are not outweighed by a correspondingly higher portfolio yield, then competition itself will provide the correct incentive to discourage high turnover.

High turnover may be beneficial and should be permitted whenever it is justified.

Turnover creates liquidity; indeed it constitutes an integral part of the definition of liquidity. In fact, a second and closely related facet of turnover is its influence on the amount of price change required to make a security move from one owner to the next.

There is no reason to believe *a priori* that higher turnover implies greater market volatility. There is a widely accepted presumption in all financial markets that prices will be smoother (changes less abrupt) in high-turnover instruments in part because liquidity is greater and prices can better reflect fundamental value. Naturally, instances of "one-way sentiment" (e.g., overwhelming pessimism) can occasionally distort the longer term trends of the market.

The proposal's sponsors express the hope that the tax will reduce securities market volatility. In fact, the tax could very well increase volatility by discouraging pension funds from searching out and buying stocks at bargain prices when the equities market is in a general decline. If pension funds were to be discouraged from buying at such times, panic selling declines in the equities markets would be deeper.

Conversely, the tax would discourage funds from selling stocks which, in the assessment of the fund's portfolio managers, are greatly overpriced with respect to their fundamental value (e.g., present value of future earnings stream). Such sales would tend to move the aberrant market price back toward fundamental value and would thus be a stabilizing influence. Since it cannot be known what net impact such a tax would have upon market volatility, imposition of the tax would be a legislative experiment which could have unexpected, harmful, and far-reaching results.

Institutions are not short-term oriented and there is, accordingly, no need for a tax to encourage them to invest for the long-term.

Neither ERISA nor pension plan sponsors impede managers from competing freely on the basis of long-term performance. Based on previously cited data, institutional managers do, in fact, invest for the long-term, as well as the short-term, as the situation warrants. As regards ERISA, Ann Combs, Deputy Assistant Secretary of Labor (Pension and Welfare Benefits Administration) has stated that, with respect to tender offers, "plans are not required to tender their shares if, based upon a thorough and objective analysis, it is reasonable to anticipate that they will achieve a higher economic value by holding the investment than by tendering or selling into the market and reinvesting the proceeds" (ACLI Pension Forum, March 1989).

As regards requirements imposed by pension plan sponsors on investment managers, most experts in the field agree that in the presentations to obtain assets for management and in later performance reviews, the question of the appropriate time horizon is an intensely discussed subject with a wide variety of viewpoints. Once the time horizon is decided upon by the plan sponsor and manager, plan sponsors, as a rule, make changes only after the agreed upon time period has expired. This usually involves several years. As a rule, fund managers are hired for the long-term and are judged on their long-term investment results. It is simply too expensive and time-consuming for plan sponsors to constantly change managers.

Measured reaction time is also supported by the relative stability of pension benefit and contribution flows, which respond to longer term actuarial calculations. It is simply not true that pension managers are "typically" under the gun for short-term performance.

The tax will not accomplish its intended goals of reducing takeover activity and improving United States competitiveness.

A tax on short-term capital gains of pension funds will not reduce takeover activity or improve United States competitiveness. Since takeover decisions are not within an investment manager's province, the investment strategy of a manager would not have an impact on such decisions. With regard to improving United States competitiveness, rather than promote long-term holding of equities, the bill would create a further bias against equity investments.

Existing evidence does not support the notion that pension plans promote takeover activity through investments in junk bonds or LBO funds. As Deputy Assistant Secretary of Labor Ann Combs noted in the previously cited address, in all likelihood, less than 2.5 percent of the total $2 trillion in pension plan assets are invested in LBO and junk bond funds. She stated that, "we [the Department] do not believe that changes in ERISA relating to plan investments and LBO funds or high-yield non-investment grade bonds are warranted." An August, 1989, GAO study confirms the Department's belief finding that eight large public and private plans had only 3.7 percent of their assets invested in 53 LBO funds. Moreover, they found that public plans had a higher share of assets in LBOs than private plans.[4]

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In summary, there are no valid policy reasons for the proposed tax on pension funds. There are distinct dangers in jeopardizing capital formation through pension funds. The growing unease among thoughtful citizens about the possible existence of a short-term orientation of American corporate leadership and institutional investors will be cause for much debate in the current decade. The proposed tax would not be a remedy for that problem, if it does exist.

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[4] GAO, Leveraged Buy-Out Funds: Investments by Selected Pension Plans, Washington, August 1989, GAO/HRD-89-121.

STATEMENT OF THE AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

The AFL-CIO appreciates the opportunity to comment on the effects of short-term trading on long-term investment and proposed legislative measures to tax pension fund gains on short-term investments. We strongly support Congressional investigation and oversight into these issues. However, we believe that legislative proposals intended to curb short-term trading by taxing pension gains from short-term trades is the wrong solution to this important problem. Such proposals unfairly use workers' pension fund money to pay for decisions they did not make or actions they did not take and unfairly single out pension funds as the only investors responsible for fostering a short-term investment perspective In addition, these proposals establish a dangerous precedent for the taxation of employee benefits.

I. LABOR'S STAKE IN A LONG-TERM INVESTMENT PERSPECTIVE

This country's workers unduly have borne the casualties of business' short-term investment perspective. For, in many cases, their pension assets, have been used to finance corporate takeovers which have cost jobs and reduced the value of workers' economic security. Between 1985 and 1988, companies involved in mergers and acquisitions stripped $ 8 billion in pension fund assets by terminating their plans and recapturing so-called "excess assets. In prior testimony the AFL-CIO documented that over the last decade 90,000 union workers have lost their jobs as a result of corporate reorganizations. Only now are benefit experts beginning to assess how the leveraged buyout mania has increased health care costs of workers in targeted companies and shrunk the local tax base of communities ravaged by plant shutdowns.

Worker pension fund assets have also been used to finance the excessive transaction and deal making fees charged by brokers on short-term trades. Investment managers have felt pressured to strike such deals because they are evaluated by plan sponsors in terms of investment returns. In essence, managers are faced with perverse financial incentives to employ a short-term investment perspective.

Workers are also concerned about the long-term health of our economy and our ability to compete internationally. Pensions funds, as significant owners of corporate America and active investors, can reclaim the job from corporate raiders of weeding out ineffective and unaccountable corporate management.

A long-term investment horizon is critical for this country's prosperity but taxing pension short-term gains opens up a pandora's box of policy and practical problems.

II. POLICY CONSIDERATIONS OF TAXING PENSION SHORT-TERM GAINS

Taxing Pension Fund Assets is Nothing More than Blaming the Victim: Why should workers' deferred wages be used to pay penalties for decisions they did not make or actions they did not take? Workers have traded wages and benefit improvements to pay for their pension fund benefits in the form of deferred wages. Workers, therefore, have an ownership share in pension fund assets—assets necessary to provide adequate and secure retirement benefits.

As pension plan participants, workers and retirees are far removed from investment decisions, nevertheless, the penalties proposed by S. 1654 could be passed through to participants in the form of lower benefits. Furthermore, corporate and labor trustees are also removed from specific investment decisions. As a recent Congressional Research Service study shows, the majority of single employer and multiemployer pension fund trustees decide broad pension investment policy but do not oversee the day to day administration and investment of the pension fund assets. Investment responsibilities are delegated to investment managers and brokers who have the most direct financial interest in profiting from short-term trading opportunities.

If revenue concerns are not a key objective of this bill, then why not tax the profits made by the investment managers and brokers who incur them instead of charging it off to workers' potential retirement income. In addition, it seems unfair to double tax pension-dollars, once as they are invested and once again when they are received as retirement benefits. Pension fund dollars are more valuable to workers when they are invested than when they are received because, as investment dollars, they are tax free and have added earnings potential.

Workers in underfunded pensions plans also stand to lose by this approach. in 1987, 21% of pension plan sponsors had underfunded pension plans. These plans would have to adjust benefit levels or increase contributions if the tax was imposed repeatedly or even once on a significant investment return that caused expected actuarial gains to be adjusted.

WILL SUCH AN APPROACH WORK BY TARGETING PENSION FUNDS?

Recent activity on the stock markets suggest that short-term trading is on the downswing and long-term investments are on the upswing. There appears to be no evidence to show unequivocally that pension funds have shorter investment horizons than other investors.

There is, however, evidence to show that pension funds are indeed long-term investors. A 1989 survey of pension fund members of the Council of Institutional Investors, representing over $300 billion, found reporting members average annual turnover rate to be 30.19%; which is considerably lower than the 1988 reported annual turnover rate of 55% for the New York Stock Exchange. The average holding period of securities for Council members was 4.25 years.

The Council's survey also highlighted its largest member, the California Public Employees' Retirement System, as having an annual turnover rate of less than 5% and an annual holding period of 8 years. The five funds of the City of New York have an average turnover rate of 19.3%. The Council reports that there are over 50 stocks in the City's portfolio that have been held for more than 20 years each. The California State Teacher's Retirement System and the New York State Common Retirement Fund also report low annual turnover rates of 12% and 14% respectively.

This Approach Legislates the Definition of Good and Bad Investment Behavior: One reason why Congress has not, been able to legislate disincentives for leveraged buyout activities is that they cannot devise a way to delineate good from bad buyouts and because money is too fungible to follow through takeover financing. More specifically, in considering proposals to lower deductibility of interest on corporate debt, Congress encountered difficulties in determining acceptable standards of debt.

Legislative measures aimed at curbing short-term activities face the same definitional dilemmas that could presumably be addressed through explicit investment guidelines established by trustees. For example, under S. 1654, does short-term trading around a core position (e.g. securities that are intended to be held long-term) that is designed to bolster the value of core securities, fall under the exemption for hedging transactions? Would fiduciaries be able to justify short-term trading necessary to meet planned or unexpected short-term plan obligations?

Another problem with S. 1654's attempt to delineate positive from negative short-trades arises when you consider that hedging, for the most part, is executed through program trading—the main technique for index arbitragers—the masters of short-term trading for quick profits. It is conceivable that traders could hide under the cloak of the hedging exemption to justify the type of short sales S. 1654 aims to slow.

Taxing Pension Fund Assets is a Dangerous Precedent: This approach flies in the face of a longstanding national policy which grants tax exemptions to a broad range of employee benefits to encourage their sponsorship and to fulfill a public good. Employment based pensions increase the national savings rate, stabilizes employment by attracting and maintaining employees, and provides an important supplement to social security.

There also is an equity basis to the government's policy of exempting employee benefits from taxes. Tax exemptions benefit low and middle income workers more than the wealthy. If taxing employee benefits becomes policy, workers least able to compensate financially for lower benefits will be placed at risk.

Proposals to tax short term gains of pensions funds subordinate the public good and equity aspects of the tax exemption of fringe benefits to quick legislative fixes aimed at behavior modification and revenue raising. How can we expect pension fund trustees and investment managers to take a long-term perspective when Congress legislates pension policy for short-term revenue purposes and continues to shirk any efforts at strategic long-term planning for a retirement income policy.

III. ENCOURAGE LONG-TERM INVESTMENT HORIZONS

The AFL-CIO maintains the position that a long-term investment horizon is not measured simply by time. Ideally, pension funds can enhance their long-term perspective by being active investors in the companies in which they own shares. They should be able to increase their share value by monitoring the company's long-term growth, stability, and productivity as well as the effects of corporate policies on the local economy. This should be the carrot for pension plans. Unfortunately, while current law allows fiduciaries to exercise a long-term investment perspective, it falls short of allowing them to exercise fully their shareholder rights in ways that protect such a long-term perspective.

Legislative reform of the proxy system is needed to provide for confidential proxy' voting, to assure owners equal access to a secret ballot and to shareholder lists, to require mandatory disclosure of proxy votes by fiduciaries, to institute one-share, one-vote for all classes of stock, and to eliminate management's ability to broadly exclude shareholder proposals, including labor-management policies, from the proxy ballot.

We also urge Congress to reform the tender-offer process to require disclosure to workers of all information affecting the changed ownership, to increase the time given to stockholders to respond to tender offers, and to restrict certain practices associated with the sale of stock as greenmail.

In addition to reform of shareholder rights, the AFL-CIO supports other non-regulatory measures to encourage long-term investments, including specific plan guidelines formulated by trustees on investment and shareholder rights activities. These approaches may bolster a long-term perspective without the attendant problems posed by S. 1654. We look forward to working with members of the Committee on these issues.

STATEMENT OF THE AMERICAN ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

INTRODUCTION

The Association of Private Pension and Welfare Plans (APPWP) is a national association representing a diverse group of organizations involved in the private sector employee benefits system. Its members include employer sponsors of benefit plans as well as providers of plans including insurance companies and banks and those rendering services to benefit plans including investment management, actuarial, accounting, legal and employee benefit consulting firms. The APPWP's members either sponsor directly or administer health and pension plans covering more than 100 million Americans.

The APPWP's Board of Directors and its Investment and Accounting Issues Committee has had an opportunity to review and discuss S.1654, the "Excessive Churning and Speculation Act of 1989". The Committee is chaired by David M. Walker, National Director of Arthur Andersen & Company's Compensation and Benefits practice and former Assistant Secretary of Labor for Pension and Welfare Benefit programs. The APPWP appreciates this opportunity to express our concerns to the Senate Finance Committee about the potential adverse effect of S.1654 on the nation's pension system and capital markets.

OVERVIEW: THE U.S. PRIVATE PENSION SYSTEM

Before addressing the APPWP's specific concerns with S.1654, it is important to reflect upon the nation's private pension system to put into proper perspective the proposed legislation to tax certain investment gains realized by pension plans.

According to the U.S. Department of Labor, in 1950 the private pension system held $17 Billion in assets. Today, this amount has grown to more than $1.7 Trillion. Together with public pension plans, which would also be effected by S.1654, the nation's pension assets far exceed $2 Trillion. This growth in assets has resulted in enhanced benefit security for American workers, retirees and their families. Again, according to the U.S. Department of Labor, in 1974, only 34 percent of the nation's defined benefit plans were fully funded on a termination basis. Today, more than 80 percent of defined benefit plans are fully funded. This growth in assets allows the U.S. system to lead the world in benefit security measured by assets per participant. The U.S. system has set aside over $26,800 per participant. This is higher than all other countries with a funded system (e.g. Australia, Japan, The Netherlands, Switzerland and the United Kingdom). While assets per participant grew by $5,000 in Japan between 1980 and 1988, they grew by $12,000 in the U.S.

This vast system represents one of the best bargains for both those who rely upon it for retirement income and for the Federal government. For while the estimated Federal revenue loss attributed to the pension system is $47.4 Billion for Fiscal Year 1990, the benefits paid by employer plans during calendar 1988 (the most recent data available) was approximately $220 Billion according to the National Income Accounts reported by the U.S. Department of Commerce. Thus, benefits paid are 4.6 times greater than the foregone tax revenue.

Furthermore, actual benefits to the economy are much larger than shown above because the $47.4 Billion estimated revenue loss is based on contributions made and assets held for both employees and retirees; while the $220 Billion figure applies to retirees only. Stated another way, the "benefits paid" figure does not even count benefits that will be paid to future retirees--benefits which, of course, will also be taxed that time.

However one evaluates the numbers, one thing is clear: it would cost the American taxpayers far more to provide equivalent retirement income directly through public programs.

The private pension system is also one of the very few bright spots in an otherwise dismal record of national savings. Indeed, private pension plans represent the largest domestic pool of capital fueling our economy. In 1986, pension and profit sharing plan contributions formed 51 percent of new savings. That same year, pension funds accounted for 34.8 percent of the investment capital supplied by nonbank financial institutions, up from 27.6 percent in 1970. This healthy investment of pension plans helps fuel new ventures which constitute America's future.

Importantly, the excellent investment returns achieved by pension plans (12 percent from 1977 to 1986) is not purchased in a manner that compromises retirement security for pension plan participants and beneficiaries. The Employee Retirement Income Security Act (ERISA) contains a number of strict fiduciary requirements, including requiring that most plans diversify their portfolios in order to minimize the risk of large losses. This enables plans to weather short-term financial storms while preserving long-term returns. Thus, for example, when the stock market lost nearly 25 percent of its value on Black Monday, October 17, 1987, pension funds lost only about 10 percent and still finished the year earning an average of 6.6 percent.

TAXING PENSION PLAN GAINS WILL REDUCE PENSION BENEFITS, REDUCE LIQUIDITY IN THE CAPITAL MARKETS, LOWER THE NATIONAL SAVINGS RATE AND IMPEDE DEFICIT REDUCTION

All of this background is important in order to understand how significantly an excise tax on investment gains of pension funds would diminish both the benefits paid to plan participants as well as the role of the pension system in supporting our economy. S.1654 would impose excise taxes on the gains received by qualified pension plans with assets of more than $1 million. Gains on assets held for 30 days or fewer would be subject to a 10 percent tax while assets held for 31 to 180 days would be subject to a 5 percent tax.

Inevitably, retirement benefits would be adversely affected by a tax on investment gains. The reduction in benefits for defined contribution plans (such as 401(k) and other savings and profit sharing plans) is easy to see. Since the benefits paid to participants in these plans are directly affected by the return on investments, if asset transactions are taxed there would be a direct reduction in the level of benefits paid to plan participants and beneficiaries.

In the defined benefit plan arena (where the employer promises a specific benefit to participants based upon a formula) the reduction in the benefit would be indirect but just as real. Because the excise tax would not relieve the employer from paying the promised benefit, the employer's ability and willingness to pay increased benefits would be diminished. In simple terms, it would cost employers more to pay the benefits prescribed by the plan. Over time, additional employer contributions would be required. Given current competitive conditions, this increased cost would be passed on to participants and beneficiaries in the form of lower benefits.

Moreover, by taxing pension plan gains, S.1654 imposes a "double tax" on pension plans and their participants in addition to penalizing short-term investment returns. Plan participants are already taxed when the benefits are distributed to them -- including taxation of after-tax contributions which are withdrawn early. Under the bill, the pension trust also would be taxed before the distributions were made to participants and beneficiaries.

The excise tax would also have the effect of reducing liquidity in the U.S. capital markets as there would no longer be as ready a market to buy and sell certain investments. This trend has already been detected in Australia which recently adopted a trading transactions tax. Because investors value liquidity, they will price equities in our markets lower to reflect their preference. Foreign investors will seek to avoid this tax by trading American stocks in their own markets. Similarly, some American investors may prefer to trade a greater portion of their portfolios in other countries. Either way, there could be a movement of assets out of U.S. markets

As the markets become less liquid and trading volume falls, large "sell" orders will also convey much greater information about a given stock in that the willingness of the pension plan to incur the tax may indicate that the seller has some truly damaging negative insights about the asset. This could further lead to downward price spirals -- and greater market nervousness and volatility.

The adverse impact of S.1654 on the role of pension plans in the national savings rate is also evident. Whether one categorizes it as prudent and wise investment or "excessive churning and speculation" the extraordinary pension asset growth described previously is, in part, due to gains on short-term investments. Plan sponsors and investment managers faced with tax penalties on profitable investments will be forced to take into account the tax consequences of investment decisions.

Enactment of S.1654 inevitably will mean that the tax either will be imposed (and the assets of the plan diminished through taxation) or the tax will be avoided and opportunities to maximize gains for the plans will be missed. Either way, overall plan assets will be lowered. As pension assets become either taxed or investments less profitable, there will be reduced savings; thereby eroding the contribution of pensions to the national savings rate.

S.1654 will also harm the national savings rate by reducing the number of private pension plans. The frequent and burdensome changes in legislation and regulation affecting pension plans have already discouraged plan formation and continuance. In 1989, according to the Internal Revenue Service, terminations of defined benefit plans exceeded the establishment of new defined benefit plans by almost three to one. Moreover, while plan terminations rose 37 percent, the rate of new plan establishments plunged by 67 percent. The excise tax imposed by S.1654 would be yet another disincentive for employers to sponsor plans. Given the low U.S. savings rate, 2.6 percent in 1988, and the important role that pension plans play in capital formation, this nation can not afford actions that will further lower our savings rate.

In addition, this tax would have a very negative affect on our ability to deal with the Federal budget deficit by impeding the government's financing operations. If investors will be taxed on the purchase and sale of government Treasury bills of less than 180 days duration, the market for those instruments will surely dry-up. This will certainly reduce the ability of the government to raise "short-term" money and may necessitate the government's paying higher interest rates to investors to make Treasury bills more financially attractive.

Finally, Congress should not underestimate the degree to which this proposed tax on pension plans represents a significant departure from decades of national pension policy. At least since the Revenue Act of 1938, Congress has expressed its intent that pension trusts should not be taxed. This measure would represent the first step toward imposing such a tax and undermining the goals carefully enunciated and protected by succeeding Congresses and Administrations of both political parties.

THE EXTENT OF SHORT-TERM PENSION INVESTING

To better understand the impact of S.1654, it is helpful to study the extent of the short-term investment turnover targeted by the bill. Admittedly, different studies yield different data. Even the same data is subject to different interpretations. We believe that turnover data reported by the SEI Corporation, an APPWP member, representing roughly $400 Billion of assets in approximately 4000 pension plans, is particularly illustrative. According to SEI, in 1987, the average pension plan took 10.6 months to turn over the entire value of its equity portfolio. The average plan took 11.4 months to turn over the value of its bond portfolio. In 1988, the average equity portfolio turnover was 13.9 months and bond portfolio turnover was 14.8 months. In 1989, the value of the equity portfolio was turned over, on average, in 12.4 months while the value of bond portfolios turned over in 12 months. The bottom line is that average portfolio turnover has decreased since 1987.

The problem with focusing on the turnover rates for pension plans is that it begs the question of whether there is too great a focus on short-term investment and whether that focus is good or bad. Even if one would concede that pension plans engage in a short-term investment strategy -- and the SEI data above suggests otherwise -- one must ask whether the investment practices of pension plans are more or less volatile than other institutional or individual investors. Data reported indicates that activity by plans and other investors are comparable. For 1986, the most recent year reported by the U.S. Department of Labor, pension plans showed a 61.3 percent turnover; while turnover for all traders was 64 percent according to New York Stock Exchange Data.

Hence, if the practices of pension plans are roughly similar to other investors, and the market itself is simply active, then there is no justification for singling out pension plans for taxation. However, if Congress believes the data is not conclusive and, in fact, pension plans do generally have a more short-term focus than other investors, Congress must determine both the cause of that investment activity and whether it is, in fact, in the best interests of plan participants and beneficiaries. These issues are discussed below.

THE PURPOSE OF S.1654 IS NOT CLEAR

Since the introduction of S.1654, APPWP members and others have puzzled over its intent. Since the proponents of the legislation insist that revenue raising is not the bill's objective, businesses are perplexed over the bill's purpose, although they are quite clear about its harmful impact. As mentioned above, if impeding trading transactions is the goal of the measure, and if that is a valid public purpose, then there is no rationale for applying the bill only to pension plans. If the main concern of the proponents of S.1654 is, for example, program trading, then there are much more narrowly focused ways to deal with that issue, than by upsetting the operations of all pension plans.

If the bill is premised on the notion that investors, generally, and pension plans, in particular, prefer short-term to long-term investing, the case has not been made. If that were a truism, how would one explain that just last week when Goodyear Corporation announced a plan for significant investment in research and development, the market reacted very favorably. The reality is that investment strategies and the reactions of the marketplace are flexible and diverse. It is difficult to substantiate perceptions about "volatility" and short-term investment philosophies with hard evidence.

S.1654 WILL TAX ALMOST ALL PLANS REGARDLESS OF THEIR OVERALL LONG-TERM OR SHORT-TERM INVESTMENT STRATEGY

Proponents of S.1654 might argue that to the degree that asset turnover exceeds six months (i.e. 180 days) a plan will avoid the tax imposed by the bill and therefore need not worry about it. But that is not true. The turnover data for the 4000 SEI Corporation plans described previously, represents the time it took to turn over the value of the plan's entire portfolio. Hence, virtually all plans -- regardless of whether they follow a conservative or active overall investment strategy -- will have some short-term investment gains that will fall prey to the excise tax. If the purpose of the tax is to encourage a longer term investment outlook regardless of the impact on maximizing return to pension plans (a result we advise against) it is simply inequitable to penalize even those pension plans with a low overall turnover rate but which inevitably have some short-term (i.e. 180 days) investment gains.

Regrettably, S.1654 is, in reality, a tax on prudent investment performance and capital formation. The bill ignores or penalizes certain transactions that really have nothing at all to do with a short-term or long-term investment strategy. For example, an investor might make an investment fully anticipating that it will be "long-term." The investment might then modestly increase in value until suddenly the investor learns news about the investment that suggests that the long-term outlook is poor. Should the investor then be penalized for deciding to sell the investment while a modest gain can still be achieved? That hardly seems to be a fair or prudent public policy.

An example of a different but equally unwarranted result pertains to the application of the excise tax to certain types of pension plans. Defined contribution plans typically allow individual participants to reallocate their accounts among different types of investments. In order to comply with the reallocation request, an investment manager might have to sell one asset and purchase another, thereby realizing a gain. This gain has absolutely nothing to do with the investment manager's or the participant's long-term versus short-term investment strategy. It may have been triggered simply by a decision to reallocate the assets to different types of investments. Ironically, the reallocation might have been caused by the individual's desire to move the assets out of a so-called short-term investment toward something considered more long-term! Yet the excise tax would still apply -- presumably causing precisely the opposite result intended.

Another inequitable result of S.1654 is that the excise tax would apply even if the fund lost money in a given year. If the fund earned profits on investments of less than 180 days, but lost more money on investments of a longer duration, the tax would still be owed since there is no provision in the bill to offset losses against gains.

AN INFLEXIBLE INVESTMENT POLICY WOULD HARM PLAN PARTICIPANTS AND BENEFICIARIES AND DISTURB ACCEPTED AND APPROPRIATE FIDUCIARY STANDARDS

Assuming that virtually all pension plans will be taxed under this measure to some extent, one must next consider whether short-term investments that result in the tax are beneficial or harmful to plan participants and beneficiaries. One must also consider the enormous impact of the excise tax on redefining fiduciary standards for plan sponsors and investment managers.

The data outlined at the beginning of this statement on the growth of the nation's pension system should make clear that investment gains, even if they result from short-term investment activity, are in the interest of plan participants and beneficiaries. Plan asset managers have an ERISA fiduciary duty to invest assets in the best interests of plan participants and beneficiaries, balancing the potential for maximizing investment gains with an appropriate level of risk. To the extent that imposing a tax on certain transactions encourages asset managers to hold on to an investment longer than they otherwise would have, the job of the fiduciary is not only made more difficult but the result can be detrimental to the investment return of the plan.

In this regard, we believe that the short title of S.1654, the "Excessive Churning and Speculation Act" is inappropriate. Churning, refers to the practice of causing a trade to occur primarily for the purpose of generating fees for the investment manager. That is a totally inappropriate practice and violates ERISA. It is far different from a plan sponsor or investment manager's decision to make a particular short-term investment for legitimate purposes.

S.1654 may upset accepted standards of fiduciary responsibilities in other unintended ways. The bill appears to allow an exception from the tax for certain types of "hedging" transactions. Although it is not clear what type of "hedging" transactions are protected, this provision would appear to give investors more latitude in making a variety of investments in futures, options and the like. But that is really a double-edged sword. If the tax can always be avoided by engaging in a "hedging" transaction, one might argue that an investment manager has always committed a fiduciary breach for wasting plan assets if the plan ever incurs the tax when it could have been avoided.

ERISA fiduciary requirements already require investment managers and plan sponsors to act in the interests of plan participants and beneficiaries. If that necessitates a high level of asset turnover then, by definition, that behavior is not "excessive". If there have been abuses of existing requirements, then Congress should identify those rather than essentially redefining fiduciary standards through the tax code. In reality, investment managers are not solely short-term or long-term oriented. Rather, they seek a mix of investments to ensure a prudent balance of investment return and security of the pension assets.

THE CLAIMS THAT INVESTMENT MANAGERS ARE TOO SHORT-TERM ORIENTED ARE UNSUBSTANTIATED

Critics of short-term investments contend that investment managers are too preoccupied with short-term results and that investment managers must prove profitability every fiscal quarter or fear dismissal. While it is probably true that many pension plans review their performance quarterly, plan trustees and asset managers will confirm that it is highly unusual for asset managers to be hired or fired on the basis of such short-term performance. ERISA requires pension plan trustees to regularly review the investment performance of the plan's asset managers. It goes without saying that this frequent oversight is in the best interests of plan participants and beneficiaries.

It is simply not the case that asset managers are typically hired or fired on the basis of quarterly performance. A survey by Sentinel Pension Institute shows that quite the opposite is true. In 1987, pension plans surveyed were asked the average length of time investment managers that the plan had terminated within the past five years had been engaged by the plans. The plans reported that none of the investment managers terminated had provided services to the funds for less than one year. 92.5 percent of the investment managers served the funds for more than two years and fully 40 percent of the investment managers were still providing services for more than five years. And, of course, this data refers to the investment managers that were terminated -- not the ones who had been providing investment services for more than five years and had not been terminated.

LEGISLATION AND REGULATION FOSTERS SHORT-TERM INVESTMENT STRATEGIES

If Congress is convinced that pension and investment managers are too "short-term" oriented and believes that short-term investments are inappropriate and therefore should be taxed, then it is important for Congress to recognize the role that recent legislation, regulation, and accounting standards have played in forcing pension plans to adopt a more short-term focus on investments. Ideally, individual short-term investments represent a conscious and desirable decision by plan trustees and investment managers to maximize a plan's investment gain where in their judgment it is possible to do so. But an overall increased trend toward short-term investment strategy by pension plans is, at least in part, the result of 1.) legislative restrictions in plan funding that have been enacted since the passage of ERISA, 2.) Internal Revenue Service regulations and audit guidelines and, 3.) the pronouncements of the Financial Accounting Standards Board (FASB) which establish accounting standards for reporting assets and liabilities. All three combined have forced a much heavier focus by pension plan sponsors on the "current market value" of pension plans.

By forcing a greater reliance on current market value of plan assets, this trend in legislation, regulation and accounting standards has encouraged pension plan sponsors to focus more on short-term investments which provide a greater certainty of the current market value rather than on long-term investments.

The APPWP's position is that it is impossible to say that as a general rule a short-term investment is better or worse than a long-term investment. Each investment is an individual matter. Plan trustees are given the very complex but vital responsibility to make decisions using their best judgment. Because no one can accurately predict the future, they do not always make the best decision. But the growth of the pension system's assets at least indicates that overall they have been quite responsible and prudent in fulfilling their obligations. The important responsibility with which plan fiduciaries are charged has already been made more difficult by legislation, regulation and accounting rules that force many plan sponsors to focus more on short-term performance than they might otherwise like. Their function should not be further complicated by a tax that penalizes investment decisions that are arbitrarily considered to be too "short-term oriented" even if the decision was prudent and profitable.

Further, we believe that it is patently unfair for Congress to require a current market value focus and then impose a tax on short-term investments as if those investments were some "evil" perpetrated by pension plan sponsors.

S.1654 WOULD IMPOSE TREMENDOUS ADMINISTRATIVE BURDENS

Apart from the philosophical bases for opposing S.1654, there are a host of other valid reasons not to enact the proposed legislation. The number and degree of administrative burdens imposed by the bill can not be too strongly emphasized.

One burden involves the fact that every single transaction would have to be tracked and then short-term gains presumably allocated to the individual accounts of participants in defined contribution plans.

Additionally, pension managers would have to change their accounting methods. Where they currently apply accounting rules that permit them to look at the average cost of assets held in their portfolios, presumably they would be required to switch to a form of tax lot accounting so that some assumptions could be made as to whether the assets sold were on a "first in" or "last in" basis. Which accounting method applies could make a tremendous difference as to whether the excise tax would be triggered, although presumably a pension fund's choice of accounting method has nothing whatever to do with the issue of "volatility."

Aside from the onerous burdens that are known, a number of serious questions not explained by the bill also arise:

1.) Is the $1 million asset threshold of the bill applicable to an entire defined contribution plan with $1 million or to individual participant accounts within a defined contribution plan? When is the value of the account measured to determine whether a gain has been realized? At the beginning and end of a calendar year? The plan year?

2.) Many pension plans invest in mutual funds which certainly participate in ongoing trades. How is a plan administrator supposed to calculate the portion of an investment gain attributable to plan contributions made within the previous 30 or 180 days?

3.) In a defined contribution plan, how would the excise tax be allocated? Would it reduce the individual account balances of all plan participants or just those who may have made decisions resulting in short-term investment gains?

4.) How would a pension plan deal with mandatory distributions to beneficiaries required by law or pursuant to Qualified Domestic Relations Orders?

However these and other questions would be answered, it is clear that the administrative and record keeping expenses involved in fairly determining the effect of the excise tax and then adequately reporting it to plan participants and the federal government would be momentous if, in fact, it is even possible. Pension plan sponsors are suffocating under the burdens of administrative complexity and compliance costs. Congress should avoid legislative changes that will increase this complexity.

CONCLUSION

Taxation of pension plan short-term investments would result in reduced benefits to plan participants and beneficiaries. It would also diminish the positive role that pension plans play in the nation's savings rate. Imposing this tax on pension plans inequitably penalizes these plans while not affecting other investors that may or may not engage in even more volatile investment activity.

Particular short-term investments may, in fact, be beneficial to plan participants by maximizing investment returns to the pension plan. In any event, the decision to sell an investment at a particular time should be made by the responsible plan fiduciary based upon what is in the best interests of the participants and beneficiaries rather than the relative tax consequences of selling or holding on to a particular asset. Moreover, if there is a trend toward a more short-term investment outlook on the part of pension plan sponsors it is due, in part, to a trend in legislation, regulations and accounting rules that is placing greater emphasis on current market value, rather than the long-term market value of plan investments.

Administrative complexity would make the implementation of S.1654 enormously costly, again diverting plan assets away from the payment of benefits.

In light of the foregoing, we strongly urge the Congress to reject S.1654 as an unwarranted and ill-advised intrusion into the operation of the private pension system.

Thank you for the opportunity to share the APPWP's perspectives on this important matter.

STATEMENT OF THE CHICAGO BOARD OPTIONS EXCHANGE

Introduction and Overview

This statement is submitted by the Chicago Board Options Exchange ("CBOE"), the world's largest options exchange and the country's second largest securities exchange. CBOE opposes two recent proposals to tax or otherwise limit "short-term trading" of securities by pension funds -- S. 1654, introduced by Senators Dole and Kassebaum and S. 2160, introduced by Senators Sanford, Sasser and Ford.

There is no conclusive evidence that short-term trading by pension funds causes market volatility or causes corporate managers to take a short-term investment perspective, both of which are reasons given for the proposals. Trading in options by pension funds, which is by definition short-term, could be severely impacted under either proposal. This would adversely affect a fund manager's ability to manage risks, minimize transactions costs and facilitate the efficient allocation of the economy's resources without selling the fund's underlying portfolio of stocks.

To lessen the adverse effects of proposed legislation on the long-term performance of a pension fund, a broad and workable "hedging" exception is essential. The history of the so-called "short-short" rule affecting mutual funds in Internal Revenue Code section 851(b)(3) provides ample guidance about how not to draft such an exception. The substance of the hedging exception included in the Dole-Kassebaum proposal is a better approach.

Enactment of a securities transfer excise tax or STET is also undesirable.

A. Proposals to Tax Short-Term Trading of Pension Funds

1. The Legislative Proposals

S. 1654 would impose a 10 percent excise tax on gains from the sale of assets held for 30 days or less, and a 5 percent tax on gains from the sale of assets held for longer than 30 days but not longer than 180 days. The tax would apply to sales of assets by qualified pension plans, annuity plans, and simplified employee pension plans. The tax would not apply to plans with assets of less than $1 million. The sponsors have said that their purpose is to encourage pension fund managers to adopt a better long-term investment strategy by curtailing excessive "churning" and speculation.

The proposal includes an exception for gains on assets which are part of certain hedging transactions. Generally, a hedging transaction is one entered into to offset a fund's exposure to risk of loss on assets held or borrowings made. As such, hedging is a form of risk management and is the opposite of speculating. The proposal defines a hedging transaction as one which is entered into primarily either to reduce the risk of price changes or currency fluctuations with respect to assets held, or to reduce the risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred.

S. 2160 was introduced primarily as an anti-takeover bill. One feature of the bill would amend the Employee Retirement Income Security Act of 1974 (ERISA) to prohibit pension plans from selling or disposing of stocks, securities, options, futures, and forward contracts which are held for less than three months unless less than 30 percent of such plan's gross income for the fiscal year is derived from such sales or dispositions. The sponsors have stated that the purpose of this portion of their proposal is to encourage longer term investment by pension funds by stopping excessive "churning."

The three months/30 percent test is modeled on section 851(b)(3) of the Internal Revenue Code, which applies a similar rule to mutual funds. Unlike S. 1654 and the short-short rule, however, S. 2160 does not include a hedging exception to exempt legitimate hedges from the rule's computation of short-term gains.

Both S. 1654 and S. 2160 seek to address a much discussed and widely perceived problem, namely that short-term trading by pension funds is harmful because it increases volatility in the markets and causes corporate managers to take a short-term investment perspective, which in turn harms long-term growth and productivity. Implicit in these arguments is a belief that pension funds are increasing the risk of losses by adding to market volatility, thereby exposing retirees' benefits to avoidable risks. In fact, the reverse is the case.

2. Adverse Effects of Limitations on Short-Term Trading

There has been much public commentary on short-term trading. However, as is apparent from testimony presented to the Committee, there is no conclusive evidence or consensus that such trading by pension funds in particular has increased market volatility. Furthermore, there is no general agreement by market observers and analysts that perceived volatility is excessive or in some manner harmful to investors generally. Absent such evidence and a compelling reason to impose penalties on the activities of investors, the problems associated with the proposals far outweigh any potential benefits.

Restricting short-term trading may in fact increase volatility and expose investors to greater uncertainties than is perceived to be the case currently. Financial markets operate most efficiently and effectively when there is a steady flow of information on which investors can base their decisions to purchase and sell. The markets also function best when there is a high degree of liquidity which allows investors to engage in purchases and sales with relative speed and certainty. However, restrictions on trading (imposed either through tax penalties under the Dole-Kassebaum bill or tightened fiduciary limitations under the Sanford bill) will adversely affect both the flow of information and the liquidity of the markets.

Artificial restraints on trading activity would lessen the volume of information which investors use to gauge the market's current valuation of their assets and its assessments of future valuation. By definition, that would increase to some degree the prospect that investors will not receive a clear impression of the direction in which particular asset values are actually moving.

Reduced activity may also lead to lessened liquidity as fewer investors participate in fewer transactions. A decrease in liquidity increases the potential for large swings in the market (i.e., "volatility," as generally defined) and may also depress stock values. This potential for large swings will be increased as fewer investors are able to trade on small price changes in the market, so that more trading is done on large price changes. Stock values may be depressed because a less liquid market means it is more difficult to sell a stock if its owner needs to sell to raise cash, invest in something else or for any other reason. This diminished ability to sell stocks will tend to hold values below what they otherwise would be.

Limitations on short-term trading are particularly likely to disrupt the market's flow of information. As discussed below, the options market is a critical element of the larger financial market structure. By definition, almost all options trading would be short-term trading under the two proposals. If a pension fund's access to such trading were limited, a significant investment sector would be less active, thereby reducing the volume of information and level of liquidity which would otherwise exist.

There is no conclusive evidence that short-term trading by pension funds causes corporate managers to take a short-term investment perspective. Many analysts agree that corporate managers take a short-term investment perspective because of the high cost of capital in the U.S. Imposing a tax on short-term gains of pension funds -- a major source of investment capital -- would increase the cost of capital and put pressure on corporate managers to focus even more on the short-term. In addition, pension funds arguably are managed by people who already take a long-term investment perspective.

A particular concern of the CBOE is the potential effect which a tax or other limitation on short-term trading would have on the use of hedging as a legitimate risk management strategy. Hedging strategies frequently entail what the proposals characterize as short-term trading because such strategies utilize options to lock in unrealized gains (or to reduce the risk of losses) on the fund's portfolio of stocks, without forcing the sale of the stocks themselves. Since options are, by definition, "short-term" in nature, the proposals could be particularly damaging to the ability of fund managers to protect their beneficiaries. The hedging issue is discussed in detail below.

Another unfortunate and counterproductive effect of the proposals would result from the nature of the entities taxed, i.e., pension funds. Imposing taxes on the short-term gains (or transactions, if a STET is enacted) of such funds would increase the costs to corporations/employers of providing defined benefit plans by requiring larger contributions to replace the amounts paid in taxes. For other plans, the benefits provided to employees would be reduced by the tax bite. If employer contributions to pension funds must increase, companies' competitiveness will suffer. If such contributions do not increase, retirees will suffer as their benefits are decreased.

Proponents have observed that a short-term trading tax need not be a burden, if fund managers simply change behavior and avoid short-term gains. But this change may be very costly. Absent an ability to utilize short-term trading strategies in options, a fund manager may hold on to assets that should be sold, thereby incurring the opportunity cost of retaining investments which have peaked in value or, worse, have started to fall. Prudence would dictate selling and then purchasing an undervalued investment. Or, absent an ability to hedge, managers may be tempted to sell major portfolio positions once a market begins to fall, thereby worsening the volatility which the legislative proposals seek to lessen.

The proposals would be costly from an administrative perspective, as pension funds would have to keep a new set of records regarding taxable and nontaxable transactions. Tracking the holding periods of shares of stock would be complicated and costly. The additional administrative burden could adversely affect the initiation of new pension funds and the maintenance of established ones. With all of the recent focus on increasing savings in the U.S., in seems counterintuitive to interfere with and impede the largest institutional savers in the country. This interference could reduce the capital available for investment in industry tomorrow.

B. The Role of Options Markets

1. The Markets Generally

The proposals are of particular concern to the CBOE because they would have a negative impact on the ability of pension funds to utilize our market as the means for managing and limiting risks, while minimizing transaction costs and participating in the efficient allocation of our economy's resources.

The options markets enhance risk management -- including the "locking-in" of certain returns -- by enabling a pension fund manager to enter into offsetting positions which precisely offset the fund's position or portfolio. Using options for such purposes is less expensive in terms of transactions costs than is entering offsetting equity positions, thereby providing broader access to such investment strategies. The imposition of a tax on these inherently short-term positions would directly increase transaction costs.

2. Function of Hedging Activities

Options have become a particularly efficient method by which fund managers can engage in prudent hedging transactions. Therefore, any tax or other limitation on short-term trading as proposed in S. 1654 and S. 2160, should be imposed only in conjunction with a broadly applicable and workable exception for hedging transactions.

A pension fund's use of options transactions to develop hedges is consistent with the goal of extending the investment time horizon in stocks. In fact, hedging will be an essential component of a strategy which seeks to encourage investors to hold on to their underlying stocks. Hedging helps to protect funds from market volatility and enables them to engage in protective investment strategies that insulate them from price fluctuations. If fund managers are forced to retain equity positions, they should be encouraged to use hedging strategies to protect their investors from price decreases which may occur over the near-term.

3. An Effective and Workable Hedging Exemption

For a hedging exception to be of any use, it must be structured to apply to all hedging positions and it must be workable. In general, the exception should be formulated to cover all transactions entered into to reduce the risk of loss with respect to another position held by the fund.

One approach which should not be taken is that of the hedging exception to the short-short rule. The substantive parameters of the designated hedge exception in section 851(g) are far too narrow to cover all legitimate hedges. The exception only allows positions in "substantially identical property" (and others as provided in regulations, none of which have been promulgated) to constitute designated hedges. This ignores the development of sophisticated strategies which make use of options (and futures) which vary in price inversely with the fund's stock portfolio. The use of such strategies is sanctioned by the Internal Revenue Service in Private Letter Ruling 8921037.[1]

The Dole-Kassebaum proposal sets forth a more realistic, current standard as it includes in its definition of hedges any transactions entered into primarily to reduce the risk of price changes, currency fluctuations or interest rate changes. At a minimum, this standard should be used and interpreted to cover positions in substantially identical property, positions the value of which vary inversely with one another, etc. Such formulations would more accurately protect legitimate hedges without arbitrarily excluding any transactions which seek to manage risk.

But even a broad definition of hedging positions must be accompanied by a workable method for identifying such positions. Again, the short-short rule illustrates how not to impose such a rule. The record-keeping and monitoring of a fund's investments that must be undertaken by each mutual fund as a result of this requirement is costly and complicated.[2] Positions comprising a hedge must not only be identified, but amounts of long and short-term gain and loss on those positions must be monitored. The complexities and costs involved in using the exception prevent many mutual funds from availing themselves of its use. The Dole-Kassebaum proposal contains a similar identification requirement which could prove in practice to be similarly prohibitive. A workable identification provision must be developed, if a hedging exception is to be a feature which pension fund managers can utilize.

C. Other Lessons From the Short-Short Rule

Aside from the adverse effects of its inadequate hedging exception, the short-short rule provides a clear illustration of other problems that are likely to arise under the Dole-Kassebaum and Sanford proposals to diminish short-term trading by pension funds.

1. Administrative Burden

The administrative burden imposed by the short-short rule has been mentioned. Administrative costs decrease the return to mutual fund shareholders and will, if a short-term trading tax or fiduciary restriction is applied to pension funds, decrease the benefits paid to retirees or increase contributions required of employers. The additional cost imposed by an administratively difficult hedging exception would exacerbate this problem.

1/ In LTR 8921037, the IRS held that certain positions taken by a mutual fund constituted designated hedges, provided the values of the positions taken ordinarily vary inversely with one another. The ruling did not require that the position taken be with respect to substantially identical property.

2/ This administrative burden exists for all mutual funds, regardless of whether they use the designated hedge exception, because they must ascertain when they are approaching the percentage of short-term gain which will subject them to the tax. The administrative burden increases if a fund attempts to avail itself of the designated hedge exception.

2. Restricts Conservative Investment Strategies

Many mutual funds choose to avoid administrative costs and complexities by forsaking the use of derivatives. Their shareholders are hurt because this prevents the fund from employing many productive risk management strategies involving derivatives. The short-short rule thus has the effect of preventing a fund manager from using the investment strategy that is best for the small investors whose primary vehicle for participation in the securities market is the mutual fund. Large, sophisticated investors are not hampered by the rule. If a short-term trading tax or fiduciary restriction is imposed on pension funds, the same result will occur, with the small investors impacted this time being the pension beneficiaries who will ultimately bear the costs of the rule.

3. Effects of Market Volatility Exacerbated

In a volatile market, the average investors who are subject to the short-short rule are more exposed to such volatility because the rule discourages, and in some cases prevents, their fund managers from engaging in many asset-conservation strategies. Similarly, if either the Sanford proposal or the Dole-Kassebaum proposal were enacted, pension funds would be more exposed to volatility in the market.

In a volatile market, mutual fund managers may be left with the Hobson's choice of (i) hedging to protect the investors' assets, thereby realizing more than 30 percent of the fund's income from short-term gains (and being subject to a corporate level tax) or (ii) not hedging and watching the value of its unhedged portfolio drop precipitously in order to avoid the corporate tax on gains. Many mutual funds faced this specific choice during the market crash in October of 1987. If the Sanford proposal to amend ERISA were enacted, the fund manager might not even have the choice of hedging if the hedging would cause the fund to exceed the 30 percent threshold. It would be constrained by the rule to helplessly watching the value of its portfolio drop. If the Dole-Kassebaum proposal were enacted, the choices would be to hedge and pay the tax on any short-term gains realized; not to hedge and watch the value of its portfolio decrease; or even worse, to sell its portfolio into a falling market, shortening the holding period and exacerbating the decline. In any event, pension beneficiaries would lose.

4. Discrimination Between Debt and Equity Funds

The short-short rule also discriminates between equity and debt investments. Bond funds generally have a high level of fixed income which constitutes part of the gross income of a fund. Therefore, the short-term gains on sales of assets can be much higher than if there were minimal amounts of fixed income against which to be measured. The rule thus discriminates between two types of funds to no beneficial purpose.

The Sanford proposal uses the same definition of securities and would similarly discriminate. The Dole-Kassebaum proposal defines assets subject to the rule to be capital assets and thus would discriminate between funds which have large percentages of fixed income assets and those which have large percentages of assets relied on for capital appreciation. This discrimination appears to serve no beneficial purpose. A harmful result could be an artificial imbalance between fixed income equity and bond investments on the one hand and growth-oriented equity investments on the other hand.

D. Adverse Effects of a STET

A securities transfer excise tax has been discussed both in conjunction with the short-term trading proposals and as an independent proposal. Such a tax would have several undesirable effects.

As an excise tax on the simple act of purchasing or selling securities, a STET would not be based on either an economic ability to pay or a concept of gain. As a pure transaction cost, it would adversely affect the investments and retirement plans of middle and lower income Americans, as well as the income of traders. Middle and lower income individuals who depend on the investments made by pension plans for their retirement incomes and/or have IRAs which are invested in mutual funds would be harmed by a STET.

A STET would not be neutral in its market effects unless it applied to both debt and equity. If it were not applied to debt instruments, a STET would create a bias in favor of investing in bonds and other debt instruments rather than equities and related securities. If applied to some but not all debt instruments, it would create a bias in favor of the exempt instruments (e.g. savings accounts or certificates of deposit or Treasury securities).

A STET could encourage a movement of transactions to foreign exchanges because it would make investing in U.S. securities markets more expensive. Because a STET would make investing more expensive, in the short-run it would reduce the net return to savers in the U.S. economy and thereby exacerbate the tax bias in favor of consumption. This relative increase in U.S. transaction costs will be magnified by the decisions of West Germany and the Netherlands to repeal their transactions taxes. Other countries reportedly are considering similar actions.

Finally, a STET will decrease liquidity in securities markets, increase the riskiness of investments in securities and potentially lead to greater volatility in prices. It will also harm the role of the U.S. as a leader in world financial markets. For all of these reasons, a STET should not be enacted.

E. Conclusion

Proposals to tax short-term trading are aimed at a perceived problem on which there remains widespread disagreement. The remedies may actually create more difficulties than they seek to resolve. CBOE urges that neither S. 1654, S. 2160, nor any STET be adopted.

Should a proposal to tax or restrict short-term trading become inevitable, a proposal which CBOE would oppose, it is essential to include a substantively broad and administratively feasible exception for hedging transactions. The Dole-Kassebaum proposal is better drafted in this area and should serve as the basis for developing a meaningful hedging exception.

CITY OF BALTIMORE
KURT L. SCHMOKE, Mayor

1797

RETIREMENT SYSTEMS
ERNEST J. GLINKA, Administrator
640 City Hall
Baltimore, Maryland 21202-3470

March 20, 1990

The Honorable Members of the
Senate Finance Committee
C/O Laura Wilcox
Hearing Administrator
205 Dirksen Building
Washington, D.C. 20510

Dear committee members:

The purpose of this letter to respond in opposition to S.1654, "The Excessive Churning and Speculation Act of 1989", a bill which proposes to encourage long term investments by pension funds by imposing an excise tax on gains from sales of assets held less than 181 days.

The thirty thousand plus members of the Baltimore Retirement Systems, and surely the millions of other pension plan members of the rest of the country, are gravely concerned of the effects of this bill. Let me explain why and how this legislation directly and indirectly harms all members of defined benefit plans.

Senator Kassebaum is completely wrong in her reasoning that the employees of defined benefit plans are not affected by any tax imposed on their investment earnings. For the Baltimore Retirement plans, said tax would come directly out of retirees' pockets because all post-retirement increases of retirement benefits are based solely on investment earnings. The Kassebaum tax would directly reduce investment earnings.

For other pension plans, there would be an equally deleterious effect. Pension plans have only three possible sources of income: (1) employee contributions, (2) employer contributions and (3) investment income. By reducing investment income with an excise tax, any funding shortfalls would have to be made up by the employer. Said increased employer cost would then reduce the probability of any future benefit increases to the members of the pension plan. In effect, this bill both creates an indirect tax on local governments and corporations while also reducing future benefit expectations of pension plan members.

Please have this letter entered into the record of the March 21,1990 hearing on S.1654. If you need any other information or have any questions, please do not hesitate to contact our Retirement Systems Administrator, Ernest J. Glinka at (301) 396-4740 or Fax (301)396-1993.

Very truly yours,

Edward C. Heckrotte, Sr.
Edward C. Heckrotte, Sr., Chairman

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STATEMENT OF THE FIDELITY MANAGEMENT TRUST COMPANY

Introduction

Last year, Senators Dole and Kassebaum introduced the "Excessive Churning and Speculation Act of 1989." While Congress did not enact the legislation, it is certain to come up for consideration this year. The legislation would impose two new taxes on investment gains from the sale of assets. For assets held under 30 days, the tax would equal 10% of gains. For assets held more than 30 days but less than 180 days, the tax would equal 5%. Moreover, losses would not offset gains. The tax would apply to all 401(a) pension plans, 403(a) plans and SEPs (Simplified Employee Pensions). The tax would not apply to 403(b) and 457 plans.

Proponents of the bill argue that the tax would encourage long-term investing and reduce market volatility. This, in turn, would allow U.S. corporations to focus on long-term growth opportunities. However, in making this case, proponents have not demonstrated that a causal relationship exists between short-term trading by pension plans and the inability of corporations to focus on long-term goals. In the absence of persuasive data, the contrary proposition can just as easily be argued, namely, that the failure of corporations to focus on long-term goals has caused pension managers (and the rest of the market) to increasingly employ short-term trading techniques. Proponents respond that, in any event, the legislation will not adversely affect the pension system regardless of the legislation's ultimate success in achieving its perceived societal goals.

We do not agree. U.S. pension plans hold close to $3 trillion in assets. Because of the large size of this asset pool, the legislation will inevitably have significant macroeconomic effects. Our analysis shows that the proposed legislation would have the following results:

- o Deter the efficient use of capital, raising capital costs for certain U.S. industries.
- o Discourage savings.
- o Indirectly tax corporations, state and local governments and plan participants.

Deter the Efficient Use of Capital

Under the Employee Retirement Income Security Act of 1974 (ERISA), pension executives and investment managers are fiduciaries. As such, ERISA requires them to invest in a prudent manner for the exclusive benefit of plan participants. Failure to do so may result in civil (and possibly criminal) penalties. In fact, Congress increased these civil penalties in the Omnibus Budget Revenue Reconciliation Act of 1989.

The importance of this "exclusive benefit" rule is that investment managers do not engage in short-term trading for their own benefit. Managers trade so the pension plan can most effectively increase the value of its assets. This creates mobility of capital and allows companies in high growth, high return industries to expand and forces companies to exit low growth, low return businesses.

As capital moves freely, companies with high return opportunities can easily obtain capital. In this environment, there is never a capital shortage for ventures with high expected returns. This capital freedom often results in rapid changes in an industry's competitive structure and growth prospects. To illustrate this, consider a rapidly growing industry, with a large inflow of capital. This capital inflow brings new competitors and decreases expected returns for all existing competitors. Examples of this type of industry abound and include semiconductors, personal computer distributors and fast food franchisers.

Another need for capital mobility results from changes in macroeconomic variables, such as interest rates and exchange rates. These changes significantly impact an industry's competitive structure and demand for investment capital. For example, if interest rates and the dollar decline, it becomes desirable for investment capital to move to U.S. manufacturing industries, as they become more competitive with overseas rivals.

A tax on investment gains would obstruct this free flow of capital. A new tax would make pension executives and investment managers reluctant to move capital from a formerly high returning industry and reduced growth prospects to a new high returning industry. In effect, investment managers would plot their future course by keeping one eye on the rearview mirror. Investment managers would still invest prudently, but the definition of prudence would have to include tax effects. Also, the time and resources required to keep track of past investment results and tax effects would detract from the manager's ability to allocate capital efficiently.

The net result is higher costs of capital for high returning industries and lower costs of capital for low returning industries. Inability to transfer capital efficiently will raise the cost of capital for America's industries with the highest expected returns. Ironically, higher capital costs leads corporate managers, in their capital budgeting decisions, to favor projects with quicker paybacks.

Proponents of the legislation argue that capital movement would only be temporarily slowed for 180 days. However, with rapidly changing product, trade and capital markets, even a temporary blockage of capital will reduce America's competitiveness and inhibit our ability to respond to rapidly changing environments.

Discourage Savings

A recent New York Times editorial lamented the "sorry rate of savings in America." As a percentage of net national income, the U.S. saves less than any of its major trading partners.

Country	1980 - 1987 Net Savings as a % of Net National Income
Japan	20.3%
Italy	12.8
W. Germany	10.8
Canada	9.9
France	8.6
Britain	6.3
U.S.	4.2

Source: Office of Management and Budget

During a similar time span (1980 - 1988), U.S. pension assets grew 181% from $916 billion to over $2.5 trillion. This is the world's largest group of managed financial assets.

While showing the importance of pensions to overall savings, this growth did not occur in a vacuum. The private pension system is voluntary. New contributions do not automatically continue. In fact, for 1988, growth of the private pension system resulted from $145 billion in earnings and $1 billion in net cash outflows (contributions less withdrawals). (Source: Employee Benefit Research Institute.)

Continued corporate, governmental and individual participation in the pension system will depend largely on maintaining pension investment opportunities superior to those outside the system. It would be unwise for a corporation to contribute to its pension plan if the return on pension assets was less than its corporate return. On a present value basis, the corporation would be better off foregoing the current tax deduction, investing the funds in its business and paying retiree benefits from corporate assets.

To demonstrate this, consider two companies, A and B. Both make a $100 million payment to retirees ten years from today, earn 12% after-tax on corporate assets and have a 34% marginal tax rate. As a result of the new tax, the companies' expected return on pension assets drops from 12% to 11%. (The lowered investment return results from either tax payments by the plan or changed investment behavior to avoid taxation.)

Company A funds $39.1 million in a pension plan today to match the future $100 million liability. Company A receives a tax deduction of $13.3 million which grows to $36.9 million ten years from now.

Company B elects not to fund its pension plan. Its $39.1 million grows to $108.4 million at the end of ten years. At that time, it pays its $100 million liability and takes a $34 million tax deduction. Company B has $42.4 million ($108.4 - $100 + $34). This amount exceeds Company A's by $5.5 million or 5.5% of the pension liability.

The point of this analysis is that employers fund pension plans when it is in their economic interest. Additional pension taxes reduce incentives to fund plans and therefore discourage savings. The various tax bills of the late 1980s have already started this movement towards reduced funding of pension plans. Further tax disincentives will accelerate the trend.

A corollary to a lower pension funding rate is diminished benefit security for plan participants. Corporations funding retirement benefits out of corporate coffers have a much easier time cutting benefits. Congress only has to look at the recent cutbacks in retiree medical benefits to understand this point.

Indirect Tax

Pension plan assets are held in a trust. While a trust is a separate legal entity, any tax on pension trust assets is passed along to either the employer sponsoring the plan or the individual participant. This is true for both defined benefit and defined contribution plans.

In a defined benefit plan, the employer "guarantees" each participant a specific benefit at retirement. This benefit is usually a function of age, final pay and years of service. The benefit does not rely on the plan's investment performance or future employer contributions.

Since the employer sponsoring the plan fixes the benefit, it bears the burden and enjoys the fruits of investment experience. If there is a shortfall in assets, the sponsor must make up the shortfall by increasing contributions. A gains tax lowering investment performance will directly result in increased future employer contributions on a dollar for dollar basis. Thus, the tax on defined benefit plan assets is, in effect, a tax on corporations and state and local governments.

Defined contribution plans are the fastest growing segment of the pension market. Today, defined contribution plan assets represent approximately 34% of all private trusteed pension assets. Under these plans, the employer fixes the contribution, not the benefit. The participant takes the risks and enjoys the benefits of investment results. Again, investment taxes lower the plan's investment performance. In this case, participants suffer the taxes' consequences in the form of lower retirement income.

Any Federal revenues collected by this indirect tax will be partially offset by secondary tax effects, reducing the revenue gain. For example, consider a corporation that increases defined benefit plan contributions to pay the indirect tax. This increased contribution results in an additional corporate tax deduction. In a defined contribution plan, an employee will have reduced taxable retirement income as a result of the indirect tax. Both situations result in a reduction of any predicted revenue gain from the proposed legislation.

Summary

Presumably, Senators Dole and Kassebaum had legitimate intentions in introducing the Excessive Churning and Speculation Act. However, given the large size of U.S. pension plans, any small change in the taxation of pension assets will have substantial macroeconomic effects. One can determine these effects by viewing the Act's microeconomic consequences for individuals, corporations, governmental entities and industries. Unfortunately, summing these leads to a higher cost of capital for certain U.S. industries, a lower savings rate and an indirect tax on corporations, state and local governments and individuals. Congress should question whether the supposed benefits of this bill justify these economic dislocations.

Market Timing Investments, Inc. P.O. Box 28909 St. Louis, Missouri 63132 314.991.0656

MARKETIMING
INVESTMENTS

April 9, 1990

TO: SENATE FINANCE COMMITTEE

FROM: DENNIS W. COON, VICE PRESIDENT
MARKET TIMING INVESTMENTS, INC.

RE: SHORT-TERM TRADING PROPOSALS AND PROPOSAL S.1654
FOR HEARING HELD ON MARCH 21, 1990

Proposals that would inhibit or pressure an investor's decision whether to hold an investment is very damaging. An investor would not make an investment decision if they didn't believe it was in their best interest. Short-term trading is nothing new to our free-market economy, and we should continue to make every effort to keep the stock market as free as possible.

As a fund manager we seek to provide the best investment return for our clients. If we decide to change a position for our clients it should solely be our decision, and we should not have to be concerned whether we were invested for 1 day or 180 days. Our clients will decide if their investments needs are being met.

A final note in response to proposal S.1654. We should not impose tax penalties on pension funds which trade on a short-term basis. The job of the pension fund manager is to provide the best investment for the participants of the pension fund. If you regulate how long a fund manager must be in a particular investment, the manager will not be able to do his job and, and the plan participants will be lessor for it.

Short-term trading is not a detriment to our economy it is just a different approach which tries to provide the best investment return for the people who believe in it.

LET THE PEOPLE DECIDE HOW TO INVEST---NOT THE SENATE FINANCE COMMITTEE.

Anthony Meeker
STATE TREASURER

159 STATE CAPITOL
SALEM, OREGON 97310
(503) 378-4329
FAX: (503) 378-8772

March 20, 1990

The Honorable Bob Packwood
United States Senator
259 Russell Senate Office Bldg.
Washington, D.C. 20510

Dear Senator Packwood:

The potential excise taxation on all short-term profits generated from public and private pension fund investments represents the national creation of pass-through deficit to be born by current and future retirees across our nation. Currently, it is estimated that these total pension fund assets amount to a massive $2.6 trillion. Unfortunately, these funds are being eyed as a benign revenue enhancement source to tap as a national budget deficit reducer or as a replacement revenue source needed to shore up budget reductions caused by a capital gains tax cut. Regardless of the reason for the proposed taxation of pension fund profits, the ultimate impact of such a myopic decision will be to federally shift deficits onto the backs of current and future public employes.

How will this federal deficit shift take place?

The taxation of pension fund profits is a direct federal raid on dollars earned for future retirement needs. Pension funds are supposed to operate on a fully funded basis. In other words, obligations should never exceed current or expected cash flow projections. This is currently not the case for our Social Security System. This is currently not the case for many, if not all, state operated pension fund systems in our country. I venture to say that the same statements would apply to private pension funds as well. Yet, knowing these stark financial facts, we find ourselves caught up in a national debate aimed at robbing today's private and public pension funds to solve our federal deficit and/or federal tax collection cuts.

The taxation of pension fund profits creates a new black hole economic theory and sets a new standard for social investment enthusiasts to support and exploit. Currently, over 194,000 Oregonians participate in our Public Employees Retirement System. For every 1% in increased earnings on pension funds there is a compounded decrease in employer contributions of 15% to 20% over the life of the employee. In short, pension fund profits directly decrease or greatly reduce the amount of taxes Oregonians must contribute toward pension fund benefit payments. I believe most Oregonians would vehemently object to this slight-of-hand tax increase passed along to them in this "revenue enhancement" package.

Bob, the health of Oregon's pension fund is critical to all Oregonians. It is vital to the retired teacher from Prineville. It is vital to a career public servant from Medford scheduled to retire after 25 years. It is vital to the beneficiaries of employees who are struggling to pay bills out of their dedicated trust funds. As you know, we in Oregon have long taken pride in our ability to plan today for tomorrow. The imposition of this tax will greatly restrict our next decade of legislators as they grapple with funding education, crime programs or matching retirement benefit requirements and, ultimately, taxpayers will be asked to foot the bill for this ever compounding pension tax black hole.

In my estimation, today's pension fund managers are not short-term speculators in search of a fast buck. Our mission is to maximize returns for investments through prudent practices. Those practices include short-term trading and short-term profits. Pension fund operations are not the creators of our national federal deficit. We view the proposed pension fund excise tax as nothing more than the federal seizure of a percentage of our future retirees benefit payments.

I urge you to do everything in your power to protect Oregon's Public Employees Retirement System against a federal raid on its future and reject the proposed excise taxation of pension fund profits.

Sincerely,

ANTHONY MEEKER
State Treasurer

STATEMENT OF MERRILL LYNCH CONSUMER MARKETS

Mr. Chairman, we at Merrill Lynch want to commend you for your leadership in the effort to restore tax incentives to increase personal saving. Merrill Lynch manages over $41 billion in IRA assets and is the largest provider of IRAs in the United States. In addition, we have a relationship of trust with over 4 million households whose savings are in excess of $271 billion.

We share your concern that the United States is not saving enough to remain globally competitive as a Nation or financially secure as individuals. We agree with you that increasing our Nation's saving rate is one step that should receive broad, bipartisan agreement and support.

Increasing our personal saving rate is crucial, both for individuals and for the Nation's future prosperity. Our personal saving rate is now among the lowest in the industrialized world, and we must take steps to improve it if we are to remain a leader in the world economy.

That is why we believe it is so important to enact tax incentives to encourage people to save, and why we are encouraged that Congress is moving to adopt incentives to promote saving.

Recent efforts to enact tax incentives for saving have been hurt by the belief that they do not work. However, given our experience with IRAs, we were skeptical about this view and commissioned a number of studies to determine the effectiveness of saving incentives.

The collective results provide strong evidence that:

- The IRA, from 1982 through 1986 worked; it increased National saving, and will provide retirement security to a broad cross section of people.
- Well-designed saving incentives, like the IRA ('82-'86), will stimulate additional personal saving.
- Well-designed saving incentives have appeal to Americans at all economic levels.
- Public policy, through the use of tax incentives, can positively affect personal saving behavior.
- The saving crisis is real - not imagined.
- Regardless of statistical differences, our foreign competitors simply save more as individuals, and thereby invest more in their Nations' futures than do we.

In June 1989, we released the results of a study entitled "Save, America," conducted by the Institute for Research on the Economics of Taxation, which concluded that IRAs were a powerful generator of new saving by middle-income taxpayers before they were restricted in 1986.

In November 1989, Merrill Lynch published the results of a Lewin/ICF study on the evidence linking tax incentives and saving behavior. The study was designed to answer three questions: (1) what were the past effects of IRAs on personal saving; (2) what effect did changes in IRA legislation have on saving behavior; and (3) what effect could new IRA tax incentives have on future saving behavior and the U.S. economy?

The results systematically refute a number of myths regarding tax incentives in general, and the IRA specifically.

Myth #1: Tax incentives do not increase personal saving - they merely promote the shifting of funds from other saving vehicles.

Findings: Most contributions to IRAs represent new private saving. The Lewin/ICF analysis found no indication that people shifted funds out of other forms of saving in order to contribute to an IRA, or contributed funds that they would have saved anyway in another form. After controlling for various other factors that might affect saving, IRA contributions were found to be positively related to other saving. This means that, generally, individuals who contributed to IRAs saved more in other forms, not less. They neither shifted nor reduced other saving to contribute to their IRAs.

Lewin/ICF also investigated the effects of IRAs on aggregate household saving by analyzing data relating household acquisition of financial assets (excluding IRAs) to IRA contributions, disposable income, the rate of interest, unemployment, change of GNP, change in stock market values, inflation, and pension plan contributions. Again, it was found that IRA contributions were positively related to non-IRA saving.

Myth #2: IRAs only provide tax incentives for the wealthy.

Findings: The majority of IRA contributors are middle income! In 1978, 75 percent of IRA contributors were persons with family incomes of less than $40,000. In 1982, 55 percent of the persons contributing to IRAs had family incomes lower than $40,000.

Myth #3: Public policy, through the use of tax incentives, cannot affect personal saving behavior.

Findings: When IRAs were curtailed in 1986, annual contributions dropped from nearly $38 billion in 1986 - almost one-third of personal saving - to only $14 billion in 1987. The personal saving rate fell to 3.2 percent in 1987, the lowest since 1947. The personal saving rate has averaged 3.7 percent since 1986, compared to an average of 5.3 percent saving rate when full IRA eligibility existed. About 3.5 percent of the population aged 21 and older contributed to IRAs in 1978. This increased to 17 percent in 1982, after the expansion in eligibility, then fell to 13.8 in 1987, after eligibility was limited. About 44 percent of this decrease in participation was accounted for by persons with family incomes between $30,000 and $50,000.

Other prominent researchers such as Glenn Hubbard (Columbia Business School), Steven Venti and David Wise (Dartmouth and Harvard, respectively), Lawrence Summers and Chris Carroll (Harvard), Jonathan Skinner (University of Virginia) and Daniel Feenberg (National Bureau of Economic Research) have had similar findings.

Based on these insights, Merrill Lynch began to explore with consumers their general saving motivations and habits. We discovered that age 59 1/2 was an eternity to most thirty year olds. Saving for retirement is only one saving concern. Other life-cycle events, such as a home purchase and education, were compelling saving issues.

We also began investigating the value and timing of tax incentives and became convinced that a "back-end" incentive would be a viable proposal.

We found that a "back-end" vehicle - with a tax exemption on amounts withdrawn from the account, as embodied in the IRA-Plus (S.1771) or Family Savings Account (S.2071), - could be a powerful personal saving incentive without further burdening the current budget deficit.

The Lewin/ICF study also modelled a "back-end" tax incentive using the proposed IRA-Plus design (S.1771). Their model projected the macro-economic effects of such a vehicle on both personal saving and capital accumulation.

The study found that the benefits to the economy from an IRA-Plus would be considerable. If an IRA-Plus incentive would lead to a level of total IRA contributions equal to 1986 contribution levels, capital accumulation would increase by an additional $240 billion by the year 2000 over the current-law IRA levels and an additional $760 billion by 2030.

Further, the increased capital accumulation resulting from an IRA-Plus would have a significant positive effect on National income and output. If the IRA-Plus were to increase contribution levels back to 1986 levels, GNP would increase by an additional $19 billion over the current-law IRA levels in the year 2000 and an additional $50 billion by 2030.

In summary, "back-end" tax incentives, such as the IRA-Plus or the Family Savings Account, have the potential to increase both new National saving and GNP. If these tax incentives prompt increases in contributions and saving, as we believe, there would be a substantial rise in capital accumulation and, therefore, increases in National output well into the next century.

Despite these findings, concerns continue to be expressed about tax revenue losses that could result from tax-advantaged saving accounts like a "back-end" IRA-Plus or Family Savings Account. The comments usually assert that the near-term revenue losses would be great due to shifting of funds, and/or that long-term losses would be expected due to lost taxes on earnings produced by new saving.

As I have already noted, the empirical evidence from IRAs does not support an argument for substantial shifting of funds. On the second point, clearly that portion of saving that would be new saving would not result in a long-term revenue loss. This is because earnings on net new saving are earnings that would _not_ otherwise have occurred, and no tax would have been collected in any event. The Government could not lose what it would never have had. Furthermore, the Treasury Department has estimated that a 0.3 percentage point increase in the personal saving rate will generate enough economic growth to produce more government revenue to offset any potential revenue loss.

We also believe there is a general misunderstanding about tax incentives and their effects on National saving and tax revenues. There is _no_ simple, stable or direct relationship between tax revenues and National saving. The economic benefit of a program of tax incentives for saving does not depend solely on the amount of new saving generated or its corresponding tax revenue effects - in the short or long run.

Merrill Lynch commissioned another paper by Lewin/ICF to examine the logic of the relationships among tax incentives, the amount of new saving generated and different tax incentives for saving. The study illustrated, using varying percentages of new saving, the potential effects of tax incentives on tax revenues and National saving.

The results are compelling and show that even under very conservative assumptions about how much Family Savings Account or IRA saving would be transferred from other saving, there would still be a large initial increase in National saving and more than a sufficient increase in additional future saving to fund the government borrowing required by the reduction in tax revenues. If only one-third of the saving would be new saving, the increase in private saving would offset the reduction in public saving.

Lewin/ICF concluded that tax incentives must be evaluated in terms of their overall economic benefits - increasing National saving and capital accumulation - and in terms of personal benefits - increasing personal saving and individual financial security.

Mr. Chairman, we recognize that some members of the Committee may question whether a saving vehicle without an up-front tax deduction will provide enough incentive for new saving. Based on the evidence, Merrill Lynch believes the answer is a definite Yes.

The Tax Reform Act of 1986 changed the fundamental tax climate, enhancing the value and attraction of a "back-end" saving vehicle and reducing the value of an up-front deduction. Under the pre-1986 tax law (with its 14 tax brackets and top rate of 50 percent), the value of an up-front deduction was considerably greater than it is now, and the probability of being in a lower tax bracket at retirement was also greater.

Today, with only three income tax brackets and taxes on Social Security earnings, people can no longer be assured of facing lower tax rates in retirement. Some studies have shown that up to 60 percent of all taxpayers will face the same or higher marginal tax rates in retirement as they do while working.

In addition, an overwhelming number of people are convinced that tax rates will be higher in the future than they are today. In January of this year, Maritz Marketing Research found that 78 percent of the people they surveyed believe Federal tax increases are very likely. 59 percent of individuals queried in a February 1990 Wirthlin Group Omnibus Poll believe they will face higher taxes in retirement.

In this environment, a "back-end" vehicle, such as the IRA-Plus or Family Savings Account, is a better deal for the individual. A back-end account provides greater economic value to the retiree than its "front-end" predecessor. It also provides tax relief when most needed, during retirement.

Recent market research confirms the attractiveness of this approach with consumers. First of all, our own market research show that consumers prefer the "back-end" approach. In a just completed Wirthlin Group study of 400 pre-retirees between the ages of 45 and 64, more than 75 percent said they would save more if the Government provided them with direct tax incentives. This was consistent across all households, regardless of income.

The Wirthlin Group also conducted a poll to identify the saving account preferences of Americans. 70 percent preferred a "back-end" account like the Family Savings Account over a "front-end" account like the conventional IRA. Nearly six out of ten U.S. adults are interested in a Family Savings Account, as evidenced by their likelihood to consider opening such an account. The Gallup Organization recently conducted a saving survey which showed that 53 percent of individuals polled prefer a "back-end" account.

These results conclusively show that a "back-end" account is a good choice from the consumer's point of view. People are willing to contribute after-tax dollars now in order to secure a steady, dependable stream of tax-free retirement income later.

Finally, let me offer two additional points as to why it is essential to increase our personal saving rate: (1) saving will enable the U.S. to decrease its dependence on foreign capital, and (2) increased saving is vital for individuals to meet the financial challenges of a demographically changing society.

In recent years over half of net domestic investment has been financed by capital from abroad. While this foreign saving has contributed to U.S. economic growth, continued reliance on these inflows is not a viable policy. Over longer periods, for advanced countries, the rate of domestic investment tracks closely the supply of domestic saving. Ultimately, the U.S. must move from a position of current account deficit to surplus and capital outflow, as foreigners receive the returns on their investment in the U.S. If that is to happen without a relative reduction in U.S. living standards, U.S. productive capacity must be increased.

The aging of America adds a new sense of urgency to the need to save. As the population bulge generated by the baby boom and the succeeding birth dearth ages and reaches retirement, consumption expenditures for health care, leisure activities, long-term care, and other requirements will climb sharply, at the same time that the absolute size of the working population will be declining. Currently Americans are not adequately preparing for the costs of the future. In 1985, the median financial assets for all American families headed by persons aged 45-54 was only $600; for ages 55-64, the median was only $5,250.

To provide for the future health care and consumption requirements of a growing elderly population, we must increase our saving now: (1) to enable individuals to accumulate the financial resources to sustain longer lives, and (2) to provide future workers with the additional capital required to increase their productivity.

For America to maintain political and economic leadership, at home and abroad, we must rebuild our personal and National self-reliance by rekindling National saving.

We do face a crisis of insufficient National saving. U.S. saving has been too low for a decade or longer. The cost of this crisis is reflected in stagnant real earnings, unmet needs for more and better public and private capital, and missed opportunities for leadership at home and abroad. These problems will become more severe, especially when the time comes when foreign lenders demand a reversal of the international flow of capital and when the elderly population begins to grow rapidly in the next century.

In short, increasing our saving rate will lower interest rates, cut the cost of capital, reduce our reliance on foreign investment and improve our standard of living. Congress and the President agree: we need to save more.

Municipality of Anchorage

P.O. BOX 196650
ANCHORAGE, ALASKA 99519-6650
(907) 343-4295

*TOM FINK,
MAYOR*

POLICE AND FIRE RETIREMENT BOARD

March 23, 1990

Ms. Laura Wilcox
Hearing Administrator
Senate Finance Committee
SD-205
Washington, D. C. 20510

RE: Senate Bill 1654

Dear Ms. Wilcox:

Recently Police Sergeant Robert Nichol, Vice Chairman of the Anchorage, Alaska Police and Fire Retirement Board, was in Washington, D. C. for the National Conference of Public Retirement Systems (NCPERS). While in Washington, he visited with the Alaska Delegation and expressed the Retirement Board's serious opposition to the proposed Senate Bill 1654, titled "Excessive Churning and Speculation Act of 1990".

Attached is a Point Paper prepared for Alaska Senators Stevens and Murkowski and Congressman Young, which explains the reasons for our objections. The Public Employee Retirement Systems of Alaska, California and Texas are also in opposition to the proposed Senate Bill 1654. All four Retirement Systems are soliciting your assistance in defeating this proposed legislation.

We would appreciate your assistance in this matter. If you have any questions, please call D. Lee Wentworth at (907) 343-6440 or Martha Priddy Patterson at the Washington, D. C. office of William M. Mercer-Meidinger-Hansen, Inc. (202) 293-9427.

Sincerely,

Joe Caswell

Joe Caswell, Chairman
Police and Fire Retirement Board

JC/lhk
Attachment

ANCHORAGE POLICE AND FIRE RETIREMENT BOARD
OBJECTION TO SENATE BILL 1654
THE EXCESSIVE CHURNING AND SPECULATION ACT OF 1989

FACTS:

On September 21, 1989, Senator Kassebaum introduced Senate Bill 1654 which would amend the Internal Revenue Code to encourage long term investments by pension funds, by imposing an excise tax on gains from sales of assets held 180 days or less.

This legislation would place a 10% tax on the gains from assets that are held less than 30 days and a 5% tax on the gains from assets that are held less than 180 days.

SOLUTIONS:

The Anchorage Police and Fire Retirement Board along with several state pension plans strongly object to this thinly disguised attempt to tax pension funds for the first time and open the door for further taxation. We, along with California Public Employees Retirement System (CALPERS), the Texas Public Employees Retirement System, the Alaska Public Employees Retirement System and the Alaska Teachers Retirement System urge defeat of this legislation if it is brought forward.

BACKGROUND:

The Anchorage Police and Fire Retirement System has a diversified investment policy, investing in a wide range of vehicles: bonds, stocks, and real estate, to maximize our return with a minimum of risk. With this diversity, we have successfully weathered the various recent market crashes and realized a return that has allowed us to lower and, in some cases, eliminate contributions both from active members and the taxpayers, thereby saving millions of dollars a year. We can demonstrate that short term investments have historically been a small part of our total investments; however, the freedom to make use of them allows us to react to the constantly changing market conditions.

While we understand all revenue bills must be raised in the House of Representatives and no bill, such as Senate Bill 1654 is being discussed or scheduled, we are concerned that one might be written and passed due to the budget process and the needs for revenues.

CONTACT: D. Lee Wentworth (Alaska) (907) 343-6440
Martha Priddy Patterson (Washington) (202) 293-9427

(D.75/SB1654.Fct)

Statement of the Mutual Life Insurance Company of New York and the Prudential Insurance Company of America

On March 21, 1990, the Senate Finance Committee conducted hearings on various proposals that address short-term trading, including S. 1654, the "Excessive Churning and Speculation Act of 1989." Introduced last September by Senators Kassebaum and Dole, S. 1654 would impose an excise tax on gains from pension plan investments held 180 days or less.

The three companies sponsoring this submission together manage over a hundred billion dollars in pension plan assets. They are therefore deeply concerned about the health of the pension system in the United States.

In particular, the companies believe that S. 1654—as well as alternatives to S. 1654 discussed at the hearing, such as a generalized securities transactions tax or relaxation of the strict fiduciary rules governing private pension plan investments—proceed from false premises about pension investment practices. The companies believe that pension plans are neither villains nor victims in today's market. Rather, through sound investment practices, pension plans have grown to be an essential element of retirement security in the United States, and the largest single pool of investment capital in our economy. Because S. 1654 and related proposals are unnecessary, and detrimental to retirement security and capital formation, the Companies oppose them.

I. TURNOVER RATES, "CHURNING" AND MARKET VOLATILITY

The key assumptions of S. 1654 are that plan investment managers are "churning" pension plan portfolios, and that pension plans do not hold their investments long enough to encourage capital formation. In addition, some argue that the investment practices of pension plans are contributing to market volatility. The primary evidence cited for these propositions is that reported turnover rates for pension plan portfolios have increased in recent years. Proponents argue that these higher rates imply that pension plan managers are engaging in excessive trading and that an excise tax, by discouraging trading, would remedy any problems believed to be associated with high turnover rates.

Clearly, evaluation of the bill must begin with an understanding of what "turnover rates" measure. In general, portfolio turnover rates are calculated as a measure of the number of securities trades in a portfolio over a specified period of time. One common measure is the average of purchases and sales (calculated in terms of shares or dollar values) divided by average holdings for the year. Turnover rates do *not* measure what percentage of securities held in the portfolio at the beginning of the measurement period have been traded by the end of the measurement period. Thus, turnover rates do not directly measure how long securities are held in the portfolio.

Moreover, to place current turnover rates in historical perspective, annual turnover rates on the New York Stock Exchange since 1900 have often been much higher than current rates, sometimes exceeding 300 percent (S. Smith, "The Growth of Equity Trading in World Markets," Cornell University). Most of the changes in turnover rates appear to be related to changes in the cost of trading, including commission costs and taxes imposed by state or Federal authorities.[1] In particular, increases in turnover rates since the late 1970's appear to be largely attributable to the deregulation of brokerage commissions in 1975. Id. Even so, the recent trend appears to be toward a modest decline in turnover rates.[2]

1. There is no reliable evidence that pension plans are engaging in excessive short-term trading

Proponents of the bill simply assume that increases in the turnover rates of pension plan portfolios demonstrate that plans are engaging in excessive short-term trading. As noted, however, high turnover rates do not mean that most securities are held in pension plan portfolios for a short period of time. High turnover rates can as easily result from a small subset of a plan's portfolio being traded very actively as part of a legitimate strategy to hedge against investment risk—while most of the securities in the plan's portfolio are held on a long-term basis. In fact, the Council of Institutional Investors reports that the average holding period for a stock among a sample of its members was 4.25 years. Thus, while only limited data are available, there is no evidence to support the proposition that plans typically hold stocks only for short periods.

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[1] Compare Smith with J.H. Mulherin and M.S. Gerety, *Daily Trading on the New York Stock Exchange*, December 1989.

[2] *See New York Stock Exchange 1989 Fact Book.*

In addition, there is no basis for singling out pension plan investors for the proposed excise tax. According to the Labor Department, the annual reports filed by pension plans indicate that average pension plan turnover in 1986 was approximately 61 percent. (U.S. Dept. of Labor, Pension and Welfare Benefits Admin., *Trends in Pensions* (1989)). At the same time, average turnover rates on the New York Stock Exchange were approximately 64 percent (*New York Stock Exchange 1989 Fact Book*). By comparison, the *Mutual Fund Fact Book* indicates that turnover rates for mutual funds in 1986 averaged approximately 87 percent. Thus, pension plans appear to have lower turnover rates than many other investors.[3]

Finally, to the extent that plans do execute short-term trades, they do so to maximize returns for the benefit of plan participants and beneficiaries. For example, a plan might determine that a stock has grown to be overvalued and should be sold less than six months after it was acquired. Or, a plan that has adopted a long-term strategy of investing 60 percent of its assets in stocks and 40 percent in bonds must sell stocks when the market rises in order to maintain this balance. Yet, the bill would penalize plans for executing these trades, even though they are economically rational and in the best interests of participants and beneficiaries.

2. Pension plan investors do not discourage long-term corporate investment

Proponents who maintain that the bill will improve U.S. competitiveness assume that pension plan investors discourage corporate long-term investment in plant, equipment, and especially research and development projects. In particular, management is said to be reluctant to commit to such projects because they fear that institutional investors will react negatively (*i.e.*, sell their stock) in response to announcements of planned R&D expenditures, thereby causing stock prices to decline. One or two well-known anecdotal examples are generally advanced in support of this argument.

Contrary to the underlying assumptions of the proponents of the bill, however, stock prices are supposed to, and do, reflect a company's anticipated future income. Thus, each study that has examined the effect on stock prices of announcements of planned R&D expenditures has concluded that prices generally *rise* with such announcements. (*See, e.g., Institutional Ownership, Tender Offers and Long-Term Investments*, Office of Economic Analysis, U.S. Securities and Exchange Commission, April 1985).

Proponents of the bill nonetheless point to a few well-publicized instances in which the price of securities dropped after R&D announcements were made. These price declines may, however, simply reflect the judgment of investors that a particular R&D program is not likely to lead to future earnings sufficient to justify the investment. For example, when Federal Express announced plans to invest in "Zapmail," a new service intended to compete with the now-ubiquitous fax machine, the price of the company's stock fell nearly $10 (from the mid-$40's) in response. When Federal Express had to abandon the project several years later, the judgment of the market was proved correct and the stock price recovered, rising almost $8.[4]

Pension plan investors, moreover, have demonstrated their willingness to forego short-term earnings in favor of anticipated long-term gains. Companies in which institutional investors represent a high percentage of shareholders generally have larger-than-average R&D expenditures, and as institutional ownership increases, R&D expenditures generally increase. (*See, Institutional Ownership, Tender Offers and Long-Term Investments, supra.*) Moreover, pension plans are a major source of financing for venture capital firms, and have been eager to invest in biotechnology companies, which typically show no significant earnings for many years.[5]

3. Imposing restraints on trading through excise taxes or other means will not reduce (and may increase) volatility

According to a recent study (J.H. Mulherin and M.S. Gerety, *Daily Trading on the New York Stock Exchange*, Dec. 1989), increased turnover has not resulted in increased market volatility. Further, experience in other countries confirms that discouraging trading by increasing transaction costs (through taxes or other means) does not decrease volatility. Thus, countries with higher transaction costs did not have less volatile stock markets in October 1987; transaction costs were unrelated to the extent of the market decline. (R. Roll, *International Crash of October 1987*, April 1988).

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[3] One should take great care, however, when comparing turnover rates from different sources. Turnover rates are not always calculated the same way. For example, some formulas are dollar weighted, while others are share weighted; some formulas take the average of purchases and sales of securities, while others include only the lesser of purchases and sales.

[4] *See* G.B. Stewart, "Market Myths," *Journal of Applied Corporate Finance*, Vol.2, No. 3, Fall 1989.

[5] According to Venture Economics, pension plans provided 46 percent of all venture capital in 1988. "Venture capital Loses Its Vigor", *New York Times*, October 8, 1989.

Even if there were too much volatility, and even if short-term trading were responsible for this volatility, compelling longer holding periods would not have a positive effect on market volatility or pricing. Indeed, direct or indirect imposition of a minimum holding period would tend to exacerbate and institutionalize instability by distorting the decision-making process.[6] In fact, stock prices are particularly likely to be volatile when the market is not sufficiently liquid and there are insufficient buyers or sellers to implement trades. *Id.*

II. WE SHOULD NOT TAX AMERICA'S MOST SUCCESSFUL SAVINGS PROGRAM

Far from either undermining long-term capital investment or sacrificing investment returns through "churning," pension plans are the kind of investors that policymakers are trying to encourage. Through prudent management, pension plans have grown to be the largest single source of savings in our economy. As the *Wall Street Journal* recently reported, "the phenomenal growth of institutional money . . . in the 1980's—averaging almost 14% a year over the decade—has outstripped even the most optimistic investment projections . . . . The investment success of pension funds in the 1980's has aided workers, taxpayers and shareholders [alike] . . . ." (December 26, 1989). Indeed, private pension assets represent a higher percentage of gross national product in the United States than in most industrial countries (31.6 percent, as compared to 5.9 percent in Japan, according to Trends in Pensions, supra, Table 13.10, at 333). At a time when Congress has turned its attention to finding ways to increase the national savings rate, we should not tax—and thereby discourage—the most successful savings program in our economy.

III. RETIREMENT SECURITY WOULD BE ADVERSELY AFFECTED BY THE PROPOSED EXCISE TAX

Any excise taxes paid by pension plans would also reduce the assets available to pay retirement benefits. Sponsors of defined benefit plans would be required to make up the difference either by cutting future benefits (including enhancements to retirees) or by making larger contributions. The increased expense of providing benefits would further discourage the establishment of new defined benefit plans as well as the maintenance of existing plans. Moreover, the retirement benefits of participants in defined contribution plans would be directly reduced by the amount of any excise taxes attributable to their accounts.

The bill would also decrease amounts available to pay retirement benefits by imposing unreasonable and expensive administrative burdens on pension plans. Tracking the holding periods of individual securities would be an administrative morass. In addition, the bill does not take into account the enormous complexities that would be involved in taxing defined contribution plans, in which millions of participants typically direct the investment of their individual accounts.

Finally, the proposal would violate the fundamental tenet of our private pension system: that pension assets must be used for the exclusive purpose of providing benefits to retirees. The proposed excise tax would violate this principle by taxing pension assets to pursue objectives unrelated to retirement security. If goals as tangential to retirement security as those in the Kassebaum-Dole bill are determined to override the "exclusive purpose" provision, pension plan assets will become more vulnerable to other possibly worthy, but unrelated, goals.

IV. CONCLUSION

In sum, the Companies oppose S. 1654 for two reasons. First, the bill is based on flawed assumptions regarding the significance of pension plan turnover rates and their implications for pension plan investment practices, capital formation and market stability. Second, Congress should not discourage pension plans, which are the greatest source of savings in the United States and which provide essential retirement security to American workers, by taxing their assets prior to distribution.

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[6] *See* J. Repetti, "The Use of Tax Law to Stabilize the Stock Market: The Efficacy of Holding Period Requirements," *Virginia Tax Review*, Winter 1989.

STATEMENT OF THE NATIONAL ASSOCIATION OF REHABILITATION FACILITIES

Mr. Chairman:

This statement is submitted to the Committee on Finance by the National Association of Rehabilitation Facilities (NARF) to be included in the record of the hearing on the FY 1991 budget for the Medicare program. It addresses issues of concern to providers of inpatient rehabilitation services to Medicare patients.

NARF is the principal national membership organization of medical, vocational and residential rehabilitation facilities. Its membership includes most of the facilities excluded from the Medicare PPS as rehabilitation hospitals and a substantial number of long term hospitals and rehabilitation units which are similarly excluded.

This statement addresses four points:

1. The need to establish new base years for calculating TEFRA limits for certain hospitals and units;
2. The need for calculation of market baskets and annual updates of TEFRA limits for rehabilitation hospitals and units separate and apart from calculations for PPS hospitals;
3. Use of the 1991 market basket of 5.6% to update TEFRA limits to that year; and
4. Continued improvement of the exceptions and adjustment process at HCFA to produce fair and timely action on applications.

These all affect the payments to rehabilitation providers. For many, the per-discharge limits on reimbursement of cost imposed under the Tax Equity and Fiscal Responsibility Act of 1982 do not cover the cost of legitimate, necessary and cost-effective service. The TEFRA system was enacted as a temporary measure to limit cost increases pending the adoption of a prospective payment system. A prospective payment system was types of providers were excluded because their characteristics and patients were not reflected in the data used to construct the PPS. In 1990, eight years later, rehabilitation facilities and other excluded providers are still under "temporary" TEFRA limits.

However, as time goes by the inequities in this system intensify as programs, patient mix and patient acuity change. Also, TEFRA limits vary widely among providers, creating serious inequities in competitive relationships. New providers have limits based on current cost while older ones are subject to limits based on their costs in the early 1980s.

These defects have been magnified by the failure of TEFRA updates over this period to keep pace with costs. Until OBRA 1987, TEFRA updates for excluded providers were tied to PPS updates. As a result adjustments in market baskets to reflect site substitution, DRG coding practices and changes in technology were applied to providers under TEFRA, when none of the these factors was applicable to them. This is a gross inequity. Updates for 1989 and 1990 have been higher than for PPS hospitals, but the percentage adjustments are applied to per-discharge costs that are inadequate.

The position of providers of inpatient rehabilitation services should be addressed by this Congress.

1. THE NEED FOR REBASING CERTAIN PROVIDERS

The system of TEFRA limits is increasingly inequitable and is extracting considerable financial resources from rehabilitation providers who are meeting the needs of their patients with costs above their limits. The ultimate solution to this problem is adoption of a payment methodology that adjusts to increases in requirements and changes in the cost of providing it. In the Omnibus Budget Reconciliation Act of 1989 the Congress directed the Secretary of HHS to submit recommendations for modifying reimbursement, but it is not likely that such recommendations will be forthcoming soon. NARF has advanced to HHS the idea of examining, through research, the value of patient functional status measures as a means, along with diagnosis and other factors, of classifying patients for payment purposes. Functional status measures were recommended by earlier research as the most promising basis for a prospective payment system for rehabilitation. However, nothing has been done to explore this concept. There are no other viable alternatives in prospect.

In view of these circumstances, some action must be taken to mitigate the serious penalties being imposed by outdated TEFRA limits. NARF recommends that such action be taken in the form of adopting 1988 as the new base year for rehabilitation hospitals, rehabilitation units and long term hospitals which have exceeded their TEFRA limits in that year. The basis for and effect of this proposal are set forth in a NARF paper on the subject which is attached to this statement (without enclosures).

The need for such action is urgent and the Subcommittee is urged to include it in any package of Medicare amendments that is developed in this session of the Congress.

2. SEPARATE UPDATES FOR REHABILITATION ARE NEEDED

As described above, the fact that updates of TEFRA limits for excluded providers were tied to those for PPS hospitals resulted in annual updates of TEFRA limits falling far short of advances in the cost of treatment. This problem has been compounded by the fact that rehabilitation is very labor intensive. Personnel costs in rehabilitation hospitals and units currently exceed 64% of their total costs. This compares with an average of slightly less than 57% for PPS hospitals. Preliminary analyses of the first set of NARF survey respondents shows that rehabilitation hospitals and units continue to have a similar level of labor costs (salaries, wages and fringe benefits) if not several percentage points higher than those found in previous surveys.

This higher percentage of facility costs associated with personnel is also significant in looking at salary trends for the types of personnel related to rehabilitation, specifically, physical therapists, occupational therapists and rehabilitation nurses. These specialists are in short supply. Consequently, there is considerable competition to recruit and retain these personnel, resulting in higher salaries and recruitment costs. A NARF 1986 sample of 18 rehabilitation hospitals reported that for the then two most recently completed fiscal years (1985 to 1986), the cost for physical therapy services increased by over 7.1%; occupational therapy by 6.6%; and rehabilitation nursing by 5%. These figures were higher than other national data compiled by the University of Texas which show the mean maximum rate of change from 1985 to 1986 for maximum salary rates for registered nurses to be 5.46%; for physical therapists to be 4.46%; and for occupational therapists to be 5.66%.

A second area showing an increase in costs for rehabilitation facilities is in medical supplies. The same 1986 NARF survey referenced above indicated an increase of 27.4% in the cost of medical supplies for the 1985 to 1986 period. This is probably a function of earlier patient transfers to rehabilitation facilities, partly because of the incentives in the PPS to discharge patients earlier. Data from a small sample of hospitals that have applied to HCFA for exception and adjustment relief have shown that the time for patient referral from a PPS hospital to rehabilitation from onset of the disability has dropped dramatically. An earlier referral, while beneficial to the clinical needs of patients and their rehabilitation potential, usually means a sicker patient.

Finally, NARF recommends that there be no reductions to the market basket along the lines of policy target adjustment factors (PTAFs) as utilized previously by HHS. Excluded rehabilitation hospitals and units in the past were subject to reductions in the market basket for these PTAFs for factors that had absolutely no bearing upon excluded rehabilitation hospitals and units. These PTAFs included, for example, changes in practice patterns, site substitution, changes in case mix, productivity and the like.

Rehabilitation hospitals and units are experiencing substantially higher per-discharge costs because of the sooner and sicker phenomenon as noted above. To the extent that changes in practice patterns affect per-discharge costs, the changes that resulted from the PPS tend to increase them. Excluded rehabilitation hospitals and units are the site to which the PPS patient has been substituted. Additionally, case mix changes that have occurred generally show increased, not decreased, severity. An early unpublished study done by ProPAC showed a considerable increase in case mix. The TEFRA system does not acknowledge changes in case mix on a positive or negative basis. Thus, excluded hospitals are not able to increase revenues by upgrading their case mix through coding, commonly known as "DRG creep."

NARF also advocates the use of a separate market basket for rehabilitation -- or at least for excluded facilities, thereby recognizing the difference in higher costs, as noted above and in the NARF 1989 survey of labor costs which was sent previously to the Committee. ProPAC has recommended a separate update based on a separate market basket of 5.6%. NARF supports this proposal.

3. UPDATE 1991 TEFRA LIMITS BY NO LESS THAN THE MARKET BASKET OF 5.6%

As indicated above, there should be no policy adjustments to market basket updates of the type that are often applied to PPS. At a minimum the full market basket should be used to update limits for rehabilitation facilities.

Assuming adoption of a rebasing proposal containing the elements of the NARF proposal discussed above and in the attached paper, it is critical that future updates keep pace with inflation. Pending the calculation of separate updates for rehabilitation to reflect its unique cost structure, no less than the full market basket should be used to adjust TEFRA limits.

4. IMPROVEMENTS IN THE EXCEPTIONS AND ADJUSTMENT PROCESS CONTINUE TO BE NEEDED

The only current avenue for providers of rehabilitation to obtain relief from inadequate TEFRA limits is by applying to HCFA for an exception and/or adjustment. NARF wishes to commend HCFA for its efforts to deal with such applications fairly under quite adverse circumstances, primarily the lack of staff relative to the number of applicants. Because of the inadequacies of the system, more and more providers are being forced to seek exceptions or adjustments and HCFA is overburdened with applications.

Rebasing would reduce the number of such applications for future years, but will not affect those for years prior to 1990.

The OBRA 1989 requires HCFA to publish guidelines for exception and adjustment applications. It also explicitly authorizes the agency to adopt new base years for providers. Regulations on both provisions are expected soon. Both actions will be helpful.

One continuing problem with the present system is the period required to obtain a decision on an application for an exception or adjustment. By regulation, applications must be filed with a provider's fiscal intermediary. There is no time limit on the period that the intermediary may take to develop its recommendation and submit the application to HCFA. There have been a number of cases where intermediaries held applications the better part of a year. There should be some time limit on the period that intermediaries can take for their work. This could be done by regulation and should be. Sixty days is ample time.

Current regulations require HCFA to issue a decision within 180 days after receipt of an application (from the intermediary). This time limit should be modified to include the intermediary's review. If sixty days were given to the intermediary, HCFA would then have 120 days, an ample period. The period taken by HCFA is not determined by the complexity of these cases, but HCFA's staffing. Shorter deadlines for review would presumably increase requests for staffing, if that is what is required to meet them.

A provider who has incurred legitimate costs should not have to wait for a year or more for a determination on its case for adjustment.

If the regulations to be forthcoming from HCFA do not address these problems, legislation should do so.

5. CONCLUSION

NARF commends these positions to the Committee and urges that they be addressed in this Congress.

STATEMENT OF THE NATIONAL CONFERENCE OF STATE LEGISLATURES

THE NATIONAL CONFERENCE OF STATE LEGISLATURES (NCSL) IS OPPOSED TO S. 1654, "THE EXCESSIVE CHURNING AND SPECULATION ACT", BECAUSE THIS LEGISLATION MAY HAVE A NEGATIVE IMPACT ON STATE GOVERNMENTS. STATES ARE SPECIFICALLY CONCERNED ABOUT S. 1654'S POTENTIALLY ADVERSE EFFECTS ON: PUBLIC PENSION PLANS' INVESTMENT OPPORTUNITIES AND RATES OF RETURN, RETIREMENT INCOME OF BENEFICIARIES, THE NATIONAL SAVINGS RATE. IN ADDITION, WE OPPOSE THIS LEGISLATION AS UNNECESSARY FEDERAL PREEMPTION OF STATE AUTHORITY. NCSL, WHICH IS A NON-PARTISAN ORGANIZATION CREATED TO SERVE THE LEGISLATORS AND STAFFS OF THE NATION'S 50 STATES, ITS COMMONWEALTHS AND TERRITORIES, URGES THE COMMITTEE TO CLOSELY EXAMINE THIS WELL-INTENDED YET CONTROVERSIAL PROPOSAL. AS WITH OTHER ATTEMPTS THAT HAVE TRIED TO MODIFY MARKET BEHAVIOR, PARTICULARLY THE TRADING OF STOCKS AND OTHER INVESTMENT VEHICLES, S. 1654 COULD HAVE MANY HARMFUL CONSEQUENCES THAT NOT ONLY WOULD BE DETRIMENTAL TO PENSION FUNDS, BUT TO THE OVERALL ECONOMY AS WELL.

S. 1654 WOULD IMPOSE AN EXCISE TAX OF TEN PERCENT ON GAINS FROM PENSION PLAN INVESTMENTS HELD 30 DAYS OR LESS, OR FIVE PERCENT ON GAINS FROM INVESTMENTS HELD LESS THAN 180 DAYS. IN THIS MANNER, NCSL BELIEVES THAT S. 1654 UNFAIRLY BURDENS PENSION FUNDS WITH A NEW TAX EVEN THOUGH THERE IS NO SIGNIFICANT EVIDENCE THAT PENSION INVESTORS ARE ENGAGING IN HARMFUL, EXCESSIVE SHORT-TERM INVESTING. MOST PENSION MANAGERS, PARTICULARLY IN PUBLIC SYSTEMS, ARE BY THEIR VERY NATURE LONG-TERM INVESTORS. IN FACT, PENSION PLANS HAVE LOWER TURNOVER RATES THAN OTHER INSTITUTIONAL INVESTORS. WHILE STATE PENSION MANAGERS DO DIVERSIFY THEIR PORTFOLIOS, THERE IS A SIGNIFICANT DIFFERENCE BETWEEN SHORT-TERM INVESTING FOR A RESPONSIBLE MAXIMUM RETURN AND SHORT-TERM SPECULATION. S. 1654 FAILS TO RECOGNIZE THIS DISTINCTION. IN ADDITION, A VAST MAJORITY OF THE STATES GOVERN THEIR PUBLIC PENSION SYSTEMS UNDER THE PRUDENT PERSON RULE IN DETERMINING ALLOWABLE INVESTMENTS. PUBLIC PENSION FIDUCIARIES ARE SERIOUS ABOUT THEIR RESPONSIBILITIES AND INVESTMENT DECISIONS ARE TAKEN SOLELY WITH PARTICIPANT INTERESTS IN MIND. STATE GOVERNMENTS ARE COMPLETELY CAPABLE OF OPERATING SOUND PENSION PROGRAMS AND ANY FEDERAL INTERVENTION, SUCH AS THIS EXCISE TAX, IS UNNECESSARY AND

POSSIBLY UNWISE. RATHER THAN CORRECT "HARMFUL" INVESTMENT STRATEGIES THAT DO NOT EXIST, THIS EXCISE TAX WOULD ONLY PLACE ECONOMIC DISINCENTIVES ON PENSION INVESTORS TO DIVERSIFY, AND THEREFORE, MAY HINDER STATES' ABILITIES TO MEET CURRENT PENSION SYSTEM LIABILITIES.

THIS PROPOSED LEGISLATION WOULD ALSO VIOLATE A LONG-STANDING AND SOUND COMPONENT OF FEDERAL TAX POLICY WHICH EXEMPTS STATE PENSION PLANS FROM FEDERAL TAXATION. TYPICALLY, INVESTMENT EARNINGS ARE EXEMPT FROM TAXATION UNTIL THEY ARE DISTRIBUTED TO RETIREES. IF AN EXCISE TAX WERE PLACED ON A GAIN ACQUIRED FROM SHORT-TERM TRADING, THEN THIS LIQUIDATION OF ASSETS WOULD LESSEN THE INCOME AVAILABLE TO THE MEMBERS AND BENEFICIARIES. FOR EXAMPLE, COLORADO ESTIMATES THAT S. 1654 WOULD REQUIRE THE STATE TO PAY $2.5 MILLION IN TAXES PER YEAR, WHILE KANSAS PROJECTS ITS TAX PAYMENTS TO BE APPROXIMATELY $5 MILLION PER YEAR. STATES WOULD BE FORCED TO PASS THIS TAX BURDEN ONTO THEIR PLAN PARTICIPANTS EITHER THROUGH HIGHER EMPLOYEE CONTRIBUTION RATES OR SMALLER INCREASES IN FUTURE COST-OF-LIVING ADJUSTMENTS. SINCE STATES MANAGE THEIR PENSION FUNDS IN THE INTEREST OF THEIR BENEFICIARIES, STATES HAVE THE OBLIGATION TO RELY, IN PART, ON SHORT-TERM INVESTMENT VEHICLES THAT ENSURE HIGH RATES OF RETURN IN ORDER TO SATISFY LIQUIDITY REQUIREMENTS.

FURTHERMORE, THE BILL PLACES ADDITIONAL ADMINISTRATIVE COSTS ON PENSION PLANS DUE TO THE VOLUMINOUS RECORDKEEPING THAT WOULD BE REQUIRED. FOR EXAMPLE, THE BILL DOES NOT TAKE INTO ACCOUNT TAXING DEFINED CONTRIBUTION PLANS, IN WHICH MILLIONS OF PARTICIPANTS TYPICALLY DIRECT THE INVESTMENT OF THEIR INDIVIDUAL CONTRIBUTIONS. THIS PROPOSED LEGISLATION WOULD PLACE A TREMENDOUS BURDEN ON PUBLIC PENSION SYSTEMS, AS WELL AS PRIVATE PLANS, BECAUSE SEPARATE RECORDS WOULD HAVE TO BE KEPT FOR EACH BENEFICIARY PARTICIPATING IN A DEFINED CONTRIBUTION PLAN. EVEN FOR DEFINED BENEFIT PLANS, S. 1564 WOULD CREATE AN ADMINISTRATIVE NIGHTMARE AS A NEW SET OF RECORDS WOULD HAVE TO BE USED TO TRACK ALL TAXABLE AND NONTAXABLE TRANSACTIONS THAT THE FIDUCIARY EXECUTES.

IMPROVING THE NATION'S SAVING RATE HAS BEEN ADVOCATED BY BOTH CONGRESS AND THE ADMINISTRATION OVER THE PAST SEVERAL YEARS. NUMEROUS ECONOMISTS HAVE APPEARED BEFORE CONGRESSIONAL COMMITTEES STRESSING THE NEED FOR A HIGHER SAVINGS RATE AS A MEANS TO EXPAND AVAILABLE CAPITAL FOR BUSINESS INVESTMENTS. MANY MEMBERS OF CONGRESS, INCLUDING

CHAIRMAN BENTSEN, HAVE INTRODUCED LEGISLATION TO EXPAND INDIVIDUAL RETIREMENT ACCOUNT (IRA) TAX DEDUCTIONS, ALLOW TAX-FREE SAVINGS VEHICLES, AND LOWER THE CAPITAL GAINS TAX RATE IN ORDER TO ENCOURAGE SAVINGS. IN FACT, THERE IS SUCH UNANIMITY THAT THE HEALTH OF OUR ECONOMY DEPENDS UPON A HIGHER SAVINGS RATE THAT MANY CONGRESSIONAL OBSERVERS ARE PREDICTING THAT SOME FORM OF SAVINGS INCENTIVE WILL BE ENACTED THIS YEAR. YET, THIS COMMITTEE IS NOW CONSIDERING A TAX ON THE LARGEST INSTITUTIONAL SAVERS IN THE COUNTRY. PENSION PLANS PLAY AN ESSENTIAL ROLE IN CAPITAL FORMATION AND THIS TAX WOULD ONLY BECOME A DISINCENTIVE TOWARDS GREATER INVESTMENT AND SAVINGS.

ALTHOUGH ENCOURAGING LONG-TERM INVESTMENTS IS A LAUDABLE GOAL, NCSL DOES NOT BELIEVE THAT PLACING A TAX PENALTY ON PENSION INVESTMENTS IS THE BEST APPROACH IN ACHIEVING THE DESIRED RESULTS. WE URGE THE COMMITTEE TO CONSIDER TREASURY SECRETARY NICHOLS BRADY'S RECOMMENDATION, "THE BEST WAY TO ENCOURAGE PENSION FUNDS TO HOLD INVESTMENTS FOR A LONGER PERIOD IS NOT BY ASSESSING A TAX ON SHORT-TERM TRADING BUT RATHER BY CHANGING THE PENSION LAW RULES." JUST AS PUBLIC PENSION FIDUCIARIES MUST BE COGNIZANT OF THE LONG-RANGE NEEDS OF ITS MEMBERS AND BENEFICIARIES, THE COMMITTEE SHOULD EXPLORE AVENUES THAT MAKE IT CLEAR THAT THE FIDUCIARY'S RESPONSIBILITIES ARE BEST ACHIEVED BY LONG-TERM INVESTING, AND NOT BY SHORT-TERM SPECULATIVE TRADING.

FINALLY, NCSL BELIEVES THAT S. 1654 UNFAIRLY PREEMPTS STATES' AUTHORITY OVER PENSION INVESTMENT PRACTICES WHEN THERE IS NO EVIDENCE THAT PUBLIC PLANS ARE ENDANGERING THE SAFE OPERATION OF FINANCIAL MARKETS OR THE BENEFITS OF EMPLOYEES AND RETIREES. AS WAS STATED EARLIER, THIS WELL-INTENDED PROPOSAL COULD HAVE MANY UNINTENDED CONSEQUENCES AND THE USURPATION OF STATE AUTHORITY OVER THEIR OWN PENSION SYSTEMS IS ONE OF THE MOST DISTURBING. WHERE THERE IS NO NEED FOR FEDERAL INTERVENTION, NCSL MUST STRONGLY OPPOSE ALL ATTEMPTS THAT TRY TO IMPOSE FEDERAL AUTHORITY OVER THE LEGITIMATE EXERCISE OF STATES GOVERNING THEMSELVES. IF THE SENATE FINANCE COMMITTEE WISHES TO MOVE FORWARD ON S. 1654, NCSL RESPECTFULLY SUGGESTS THAT PUBLIC PLANS BE EXEMPTED FROM ITS PROVISIONS.

THANK YOU VERY MUCH FOR THIS OPPORTUNITY TO EXPRESS OUR VIEWS. IF THERE ARE ANY QUESTIONS, PLEASE CONTACT NCSL'S WASHINGTON OFFICE.

STATEMENT OF THE NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS

My name is Robert A. Georgine and I am presenting this testimony in my capacity as Chairman of the National Coordinating Committee for Multiemployer Plans.

The Coordinating Committee is a nonprofit, tax-exempt organization established after Congress enacted ERISA in 1974. It consists of representatives of more than 190 pension and welfare plans, or their sponsors. On behalf of its affiliated plans, and the approximately nine million participants and beneficiaries of multiemployer plans generally, the NCCMP is entirely engaged in monitoring the development—legislative, administrative, and judicial—of the laws relating to the structuring and administration of multiemployer pension and welfare plans.

On behalf of the Coordinating Committee, I urge you not to attempt to correct any problems perceived to stem from short-term trading in securities by taxing any portion of the investment income of pension or other employee benefit plans, as proposed in the Excessive Churning and Speculation Act of 1989 (S. 1654) ("Bill"), or through any other mechanism. The Coordinating Committee supports the policy of encouraging pension funds to make long-term investments, consistent with plan needs. Tax disincentives, however, are an inappropriate and dangerous mechanism for achieving this goal.

As you know, the Bill would impose an excise tax on gain from the sale of assets held by pension plans for 180 days or less. Enactment of such a tax would violate the fundamental principle, established nearly seventy years ago, that tax-exempt status should be provided to employee benefit funds. These funds are essential to the economic and physical well being of working Americans and relieve demands on government programs. Their long-standing tax-favored treatment has been indispensable in encouraging employers to establish and maintain private employee benefit programs.

If this principle is violated, even under the limited circumstances described in the Bill, further erosion is almost inevitable. Legislators battling increasing budget deficits may find it impossible to resist the temptation to implement a deceptively simple short-term fix by expanding the circumstances in which the tax applies and/or increasing the amount of the tax. (I note that the Congressional Budget Office has estimated that a five percent tax on pension fund income would generate over 37 billion dollars in revenue over a five-year period.) This would seriously jeopardize the viability of the private employee benefits system and the retirement security of the tens of millions of working Americans and their families who rely on it. Further, in the long run, it would increase Federal budget deficits by increasing demands for direct expenditures through governmental programs.

Attempting to encourage long-term investment by reducing or eliminating the favorable tax treatment of investment income of essential employee benefit programs is fundamentally wrong and could have disastrous results. Before making the enormous change in our national retirement security policy that would be reflected in such an action, we urge you to consider the social purposes served by the current favorable tax treatment of these essential programs, the consequences of reducing or eliminating such favorable tax treatment and the available alternatives for modifying institutional investment practices.

I also note that administrative burdens associated with the Bill would be intolerable.

I. OUR NATIONAL RETIREMENT SECURITY POLICY

The pension benefits provided today through the private pension system or pursuant to Federal or state legislation are the hard-won product of years of struggle. Especially in the case of collectively bargained plans, these benefits are essential to the financial security and physical well-being of working men and women and their families, who could not otherwise afford them. These programs provide income to permit retirees to live with dignity, and without burdensome dependence on the public sector. Many also provide essential protection against post-retirement illness, forced early retirement, unemployment, and other tragedies or contingencies that interrupt workers' earning power.

Congress has long recognized and supported the important social welfare purposes served by these employee benefit programs. The deep public commitment to the fundamental values underlying these programs was evidenced by the establishment of the Social Security System in 1935. Through the income, health and disability components of Social Security, workers and unemployment compensation, and other similar programs, government has undertaken to provide, through direct government expenditures, for *minimum* essential protections. These programs were designed, however, to work in conjunction with and as supplements to private sector programs.

Thus, since 1921, Congress has provided favorable tax treatment to foster the growth and development of these vital programs in the private sector. This has encouraged workers, through collective bargaining representatives and otherwise, to bargain for these protections against significant health and economic risks. Employers have also had incentives to participate in this process. These modest incentives have been very successful in getting private sector employers to provide essential benefits to a broad cross-section of employees, especially lower-paid workers. The vast majority of employee benefit recipients are lower and middle-income individuals, who rely on their employer-paid benefits for their own and their families' security.

In 1974, Congress enacted one of the most important pieces of public policy legislation ever to emanate from the legislative process. That legislation—ERISA—was also a clear statement of our long-standing national policy to encourage private sector employee benefit plans while at the same time assuring that benefits are protected and provided on a nondiscriminatory basis. Congress recognized at that time that only with the cooperation of the private sector could we achieve meaningful levels of pension, health and other benefits. Congress also required plans to meet basic minimum standards so that the hard-earned promise to pay benefits would not be illusory.

In short, our Federal tax policy and laws were designed to encourage private sector programs which, when combined with public programs and private savings, will provide working Americans with essential employee benefits, including adequate retirement security.

II. ELIMINATION OR REDUCTION OF TAX INCENTIVES WOULD BE COUNTERPRODUCTIVE

Elimination or reduction of the current tax exemption for employee benefit plan investment income, in the long run, would significantly increase budget deficits. To the extent that funds available to finance benefits through private employee benefit programs are reduced as a result of taxation of plan income, demands on government programs would be increased. Further, a reduction of the tax incentives designed to foster establishment and growth of vital private sector programs could seriously jeopardize the viability of such programs. The result would be further increased dependence and demands on government programs, which are already facing severe financial crises. I also note that, to the extent that the additional costs to these plans can be made up through additional employer contributions, those additional contributions will be tax deductible and will offset even short-term revenue gains.

In short, the imposition of additional tax burdens, as a result of short-sighted, piecemeal legislation, with inadequate attention to and consideration of the many and serious relevant policy concerns and long-term consequences would be a serious mistake. It would ultimately increase significantly Federal budget deficits and dangerously undermine the retirement, financial and physical security of working Americans and their families.

III. ADMINISTRATIVE BURDENS

In addition to these extremely serious concerns, I note that the administrative burdens associated with the Bill would be intolerable. For example, many pension funds invest in mutual funds. Mutual funds are themselves constantly making sales and exchanges of their investments. How could a pension fund determine the taxable portion of its gain on the sale or exchange of such an investment?

In addition, many defined contribution plans permit employees to direct their investments or to select investments from a menu of alternatives with respect to their individual accounts. These plans typically permit employees to change their elections periodically. Tracking and determining the taxation of each such transaction would enormously complicate the administration of plans.

IV. AVAILABLE ALTERNATIVES

If the goal of the Bill is not to raise revenues, but to prevent churning, there are more equitable, more effective and far less dangerous alternatives for achieving that goal. The most obvious would be to prohibit the sale or exchange of publicly-traded securities that have been held for less than six months or some other designated period of time. Exceptions or special rules could be provided where appropriate to avoid inequity, *e.g.*, upon the death of the holder.

Significant progress towards this goal could also be made by modifying existing regulatory disincentives to long-term investing. Congress should encourage long-term investment by rejecting the current regulatory emphasis on short-term investment returns.

I also want to stress that any change intended to affect investment practices of pension plans should be done, not through changes in the Code, but through changes in substantive law, such as Title I of ERISA and should be considered thoroughly by all relevant Congressional committees.

If you have any questions, or if we can be of any further assistance on these issues, please contact Vivian H. Berzinski of our professional staff at (202) 872-8610, 1200 New Hampshire Avenue, N.W., Washington, D.C. 20036.

Statement of the National Rural Electric Cooperative Association

Mr. Chairman, I am pleased to submit this statement to the Committee. My name is Anthony Williams, and I am director of the Retirement, Safety, and Insurance Department of the National Rural Electric Cooperative Association. NRECA is the Washington, DC-based service organization that represents the nation's 1,000 nonprofit consumer-owned rural electric systems. Among its services to member systems, NRECA makes available a defined benefit plan covering over 45,000 employees and holding—in trust, over $1.8 billion in assets.

We are strongly opposed, both in form and in concept, to S. 1654, the Excessive Churning and Speculation Act. This legislation would impose a capital gains tax of ten percent on gains from pension investments held less than 30 days and a five percent tax on gains from investments held less than 180 days.

We believe this legislation is an unnecessary intrusion into the responsibilities of pension plan sponsors and managers, and contradicts both the letter and the spirit of the Employee Retirement Income Security Act (ERISA). Furthermore, we believe this legislation would do nothing to advance its sponsors' stated objective of enhancing the U. S. economy's stability and productivity.

While we generally agree with the other witnesses' comments in opposition to the bill, we offer the following additional reasons for opposing this legislation:

- There is nothing inherently superior in long-term investments over an investment strategy that pursues a mix of short- and long-term goals, nor are long-term gains inherently better than short-term gains.
- The legislation would require pension sponsors and managers to manage plan assets in ways that might not—in fact, often will not—be in the best interests of plan participants.
- The sanctions envisioned in the legislation would easily be evaded without changing the character of investment decisions.

I would like to explain each of these concerns in turn.

ARE LONG-TERM GAINS BETTER?

S. 1654 is based on a view of pension investment managers as speculators. I must dispute this premise vigorously. A pension investment committee that approaches its task honestly will always set a long-term strategy to guide the actions of its managers. Unless a pension plan's investment strategy is designed to provide a stable accumulation of funds over an extended period of time, the pension plan will be a source of increased cost and uncertainty in the sponsor's financial planning.

To execute such a strategy, some share of plan assets will always be "quiet money," invested for the long term. In the achievement of funding stability, however, mid-course investment corrections may often be necessary. Financial markets are among the most competitive in the U. S. economy, and provide a constant flow of information on the performance and prospects of the nation's business. One firm will fall, another will be acquired, and yet another, previously unheralded, will emerge as an industry leader. Economic uncertainty generated by unstable government policies can also demand that investment managers sell or buy when they would have preferred to hold instead.

Whatever plan managers must do to achieve goals set by plan sponsors, however, the resulting gains are indistinguishable from both the employer's and the beneficiary's perspective. Short-term gains are equally as efficacious as long-term gains in meeting plan obligations to pay benefits and accumulate assets for future beneficiaries. Meeting those obligations, Mr. Chairman, should be the sole concern of the investment manager and the sponsor who hires that manager.

WHAT WILL BENEFIT PLANS AND PARTICIPANTS?

ERISA establishes a strong standard for evaluating fiduciary behavior. Under this standard, fiduciaries must manage plan assets prudently and in the sole interest of plan participants. We believe that this standard has served the nation well. When participants have been ill served by their fiduciaries, it has invariably been because the standard has not been observed, rather than because the standard itself has not provided adequate guidance, review, or monitoring of pension fund management.

S. 1654 would interpose another step between the fiduciary and the welfare of plan participants. Under this bill, fiduciaries would be required to serve participants' welfare *except when* another policy goal, entirely unrelated to retirement income policy, takes precedence.,

This, to us, is the single most pernicious effect this bill could have if enacted. Much has been made of the likelihood that S. 1654 will erode the long-standing tax deferral of contributions and investment income in qualified plans. We are concerned about the Impact of such an erosion on both savings and the retirement income of American workers. We are far more concerned that S. 1654 could open the doors to many grasping hands seeking to serve their goals with the savings of America's workers and retirees. Some court cases have already approved social Investing at the expense of plan participants, for example. We oppose any efforts to make the use of retirement assets for non-retirement purposes a matter of national policy.

We also see S. 1654 as the continuation of a disturbing inclination in proposed legislation to leave the unfinished business of Congress to America's workers to solve. We cannot tax workers for our failure to understand and control the rise in health care costs, and we cannot tax their retirement savings for our failure to compete with Japan, Europe, and the Pacific Rim nations. We urge this Committee and the Congress not to abrogate its legislative responsibilities in this way.

Proponents of S. 1654 argue that this legislation represents symmetry with proposed reductions in capital gains taxes for taxable investors. We believe that tax reductions for other investors are not symmetric with tax increases for pension trusts. If Congress wishes to promote longer-term investments, we urge the implementation of incentives for all, rather than penalties for some. If financial markets are not working properly—a long-debated thesis that is far from proven—any changes should be applied across the board, not just to retirement plans. Consequently, we also oppose Treasury Secretary Brady's suggestions that short-term trading could be restricted under ERISA rather than under the tax code, as S. 1654 would do.

WOULD PENALTIES WORK?

A final argument against S. 1654 is that it would not work. Investors' behavior is likely to display little change. An investment community that 5 was able to develop program trading, index funds, and futures markets would not be hard pressed to overcome the obstacle posed by penalties on short-term trading. It is not impossible, for example, that securities trading patterns would begin to display 31-day and 181-day surges.

The behavior of corporate management, which is the ultimate target of this bill, will also be little affected. Penalizing turnover will shelter both good and bad managers from the immediate consequences of their actions. No one gains when the penalties for poor decisions are deferred.

CAN ANYTHING BE DONE?

Policy makers truly interested in promoting economic stability, growth, and competitiveness do have options beyond S. 1654. Much instability in financial markets is due to frequent and unpredictable legislative changes and to the continuing failure, in the Administration and in Congress, to deal with the Federal budget in a fashion that financial markets find credible. We urge the Congress to abandon efforts to second-guess financial managers and to turn to those problems that only it can solve. The National Rural Electric Cooperative Association and rural Americans will work with you in this effort, but we will not do your work for you.

Thank you for this opportunity to express our views.

STATEMENT OF THE PROFIT SHARING COUNCIL OF AMERICA

The Profit Sharing Council of America (PSCA) is a nonprofit association of approximately 1,200 companies that sponsor profit-sharing and 401(k) plans. PSCA is dedicated to the task of developing, collecting and communicating profit sharing information and encouraging the philosophy and practice of sharing profits with employees, whose efforts make profits possible.

PSCA member companies employ more than 1.75 million defined contribution plan participants throughout the United States. These companies engage in every type of business activity and range in size from small, family-owned fledgling enterprises to Fortune 100 companies. All consider profit sharing to be a vital factor in their success. Because PSCA is comprised of defined contribution plan sponsors, this testimony primarily is focused on the consequences S. 1654 would have on defined contribution plans.

PSCA strongly opposes S. 1654, the Excessive Churning and Speculation Act, which proposes to tax gains on short-term retirement plan investments. Imposing a sliding-scale excise tax on plan assets held less than 180 days radically alters historical retirement plan tax treatments and fundamental fiduciary responsibilities set forth in the Employee Retirement Income Security Act of 1974 (ERISA). A tax on retirement plans' short-term investment gains will:

- alter fiduciary standards under ERISA;
- reduce retirement benefits paid to defined contribution plan participants and beneficiaries;
- subject defined contribution plan retirement benefits to double taxation; and
- discourage the efficient use of capital.

Defined contribution plans, with nearly $600 billion in net assets, not only are an important source of retirement income for millions of Americans, but also play an increasingly important role in corporate financing techniques and in U.S. financial markets. In 1987, defined benefit and defined contribution plans held approximately 24 percent of total outstanding U.S. corporate equity. Equity holdings were 35 percent of the assets of these retirement plans.

ERISA established fiduciary standards to protect retirement plan assets from losses caused by mismanagement or abuse. It requires that assets be prudently invested and diversified to minimize risk. Department of Labor (DOL) regulations require fiduciaries to ensure that investments are reasonably designed to promote liquidity, cash flow, portfolio diversification and funding objectives. If a plan sponsor or investment manager does not act in the interests of a plan's participants and beneficiaries, the fiduciary can be held personally responsible for resulting losses.

The proposed tax is more than a transaction cost; the proposal would change the fiduciary standards protected by ERISA. Supporters want to force plan sponsors and investment managers to develop investment strategies based on what they perceive to be in the best interests of the national economy, eroding the strength of the ERISA provision requiring that investments be made in the best interests of plan participants and beneficiaries. ERISA standards require that the driving concern underlying all actions by fiduciaries should be that those actions are taken for the exclusive benefit of the plan's participants and beneficiaries. Yet, if this proposal is enacted, situations will arise in which prudence would dictate selling an asset but the tax consequences would dictate otherwise, thereby putting fiduciaries in untenable positions. Fiduciaries should not be forced to subject retirement plans to taxation for doing their jobs as required under ERISA.

If implemented, the tax would decrease the retirement benefits available to defined contribution plan participants and beneficiaries. Defined contribution plan participants receive employer contributions plus investment earnings allocated to their accounts, and the tax would reduce investment earnings in two ways: short-term earnings would be reduced by the amount of the tax; and the tax may discourage fund managers from making the most profitable investments possible, thus diminishing participants' investment returns. Additionally, the tax would impose an unknown but likely large administrative burden on funds further diminishing the amounts ultimately received by participants and beneficiaries.

Also, because defined contribution plan beneficiaries generally are not taxed on contributions or earnings until they receive their benefits, the legislation would, in effect, tax beneficiaries twice: once on gains from short-term investments, and again upon distribution.

The object of this proposed tax is to encourage business executives to look to the long-term when they develop projects or devise ways to improve industrial productivity. But there is no evidence of a relationship between short-term trading by retirement funds and the lack of a long-term focus by some corporations. Moreover, enactment of the bill would delay capital movement in the United States by 180 days—and possibly cause a permanent slowdown. U.S. competitiveness depends upon the unencumbered movement of capital. Retirement plan investment trading is a major source of the capital mobility necessary for the growth of Americanbusinesses, especially those in rapidly developing industries.

Further, the behavior of plan asset managers cannot bepredicted, whether the tax is enacted or not. The tax may reduceinvestment by retirement plans in corporate equities as well asshort-term Treasury instruments. As a consequence, the proposedtax could have a destabilizing impact on the stock and bondmarkets.

The bill's advocates have not presented evidence provingthat defined contribution plans have engaged in speculation orexcessive churning, nor have they shown that short-term investmentshave hurt plan participants and beneficiaries or the U.S. economy.A recent Joint Committee on Taxation analysis of tax treatment ofshort-term trading shows that pension funds present a success storyof excellent investment returns and an ever-growing pool of savingsavailable for investment. Furthermore, the analysis indicates thatturnover rates for qualified retirement plans are about the sameas the historical rates of turnover on the New York Stock Exchange.

This bill should not be enacted. Instead of changingthe manner in which businesses plan for the long-term, thislegislation—the effects of which, not surprisingly, also willincrease Federal revenues—will unfairly penalize plan participants and harm U.S. stock and bond markets, and potentially, the U.S. economy.

STATEMENT OF THE PUBLIC SECURITIES ASSOCIATION

The Public Securities Association (PSA) appreciates the opportunity to testify on the issue of short-term trading in the U.S. financial markets. PSA is the international trade association of banks and brokerage firms that trade and underwrite U.S. government and federal agency securities, mortgage-backed securities, state and local government securities, and money market securities. Accordingly, this statement focuses on public and money market securities markets and how they could be affected by limits on short-term trading.

In particular, this statement makes two points. First, the primary policy concern about the effects of short-term trading relates to equity, not debt securities. Second, short-term trading in debt securities, and especially public and money market securities, is necessary for an efficient financial market. Limits on short-term trading of public debt securities would ultimately increase costs for public borrowers who raise money through the issuance of these securities.

This statement discusses these points with reference to any sort of limit on short-term trading in public or money market securities, since the Finance Committee has announced that it would like to consider the trading issue in broad scope. Senators Dole and Kassebaum have introduced a bill (S. 1654) which would affect short-term trading only by pension funds through a tax levied on short-term gains realized by pension funds. After a general statement of the issues arising from any limits on short-term trading, the statement will conclude with some brief remarks on the particular effects of the Dole-Kassebaum bill.

The primary policy concern about short-term trading has to do with its effects on corporate business decisions. As Senators Dole and Kassebaum described in floor statements accompanying the introduction of their bill, the fear is that investors and investment fund managers are preoccupied with short-term return. Businesses, therefore, are encouraged to favor strong quarterly earnings and the payment of high dividends over necessary investments in the company that will only show results over time.

The relationship between the planning horizon of investors and business decision-making is unclear. It is clear, however, that no linkage exists between business decisions and short-term trading of public debt securities or money market securities. Trading in General Motors stock might have some effect on GM management decisions, but trading in Treasury bonds has no effect on GM's day to day decisions. On the other hand, short-term trading in public and money market securities _is_ necessary to provide the most efficient and liquid market possible for the issuers of these securities, who are predominantly public entities.

Investors trade public and money market securities for two reasons -- to respond to changing circumstances, which could include general macroeconomic variables or the specific needs of a business or individual; and to hedge, or offset, the risk of holding other securities. These basic reasons encompass a number of specific situations. Investors in all securities frequently make use of the public securities markets, particularly the Treasury market, to hedge interest rate risk. Investors in mortgage-related assets make use of sophisticated mortgage securities as well as Treasury securities to help them offset the risk of prepayment of principal on the mortgages underlying their assets. Individuals, corporations, and pension funds that find themselves holding cash for short periods of time may purchase public or money market securities to earn a return while their funds are idle. These securities range from Treasury securities to bankers acceptances or commercial paper. The maturities of money market securities are very short and purchased with the intent of rolling them over or redeeming them when cash is needed. Moreover, in general, unexpected needs for cash, by corporations or individuals, can create the need to sell securities.

These examples illustrate the importance of short-term trading from the point of view of the investor. From the point of view of the borrower, overnight and short-term trades of public debt and money market securities are the essential ingredient of the intricate lending and financing arrangements that allow investment and commercial banks to finance their purchases and holdings of securities and thus provide capital and liquidity to borrowers across the country. For example, financial intermediaries often use repurchase agreements, often involving Treasury securities, as a means to extend credit. Under a repurchase agreement, an institution seeking credit sells securities and enters an agreement to repurchase them at a given time for a given price -- a price high enough to reflect interest on the borrowed funds. Moreover, corporations often use commericial paper as a cheaper means of obtaining short-term credit than bank loans. Limits on short-term trading would complicate the operation of the sophisticated credit system which has evolved in the financial markets, increase its cost, and reduce liquidity in the market. In general, if investors face a penalty for trading a security over a period of time, they demand a higher return to compensate for the risk that they may need to sell the security in that time period. These higher returns are passed on ultimately to issuers of the securities. In the case of public securities, the parties affected are the federal government (through Treasury bonds), state and local governments (through municipal bonds), and homebuyers (through mortgage-backed securities). These public borrowers would all suffer a higher cost of borrowing as a result of limits on short-term trading.

These undesirable results would not serve any policy goal. Limiting short-term trading of public debt would in no way increase the investment horizons of business. It would simply encourage investors to hold debt for longer periods of time, which seems clearly counter to the public interest. An analogy can be drawn from the ongoing experience of the securitization of the mortgage and consumer debt markets. Securitization has allowed lenders to sell loans quickly and easily, and therefore helped lenders deliver more capital to borrowers at lower rates of interest. By contrast, limiting short-term trading would tend to discourage the quick and easy sale of assets, increasing the risk for the holders of public securities, therefore increasing the cost of borrowing, and limiting liquidity, that is, the ability to deliver capital to the marketplace.

These adverse consequences would result from any limitation or tax on short-term trading in public securities. Clearly, the greater the scope of the limits, the greater the severity of the consequences. The bill introduced by Senators Dole and Kassebaum would only affect pension funds. According to data from the Federal Reserve Flow of Funds, private pension funds held $91 billion of Treasury securities and $52 billion of federal agency securities at the end of the third quarter of 1989. They also held $51 billion of money market and mutual fund shares, which would probably represent some holdings of Treasury securities as well as money market securities. State and local government employee retirement funds held an additional $199 billion of U.S.

Treasury securities and $68 billion of Federal agency issues. (The Committee will undoubtedly hear from state and local governments concerned about the implications of Federal regulation of public pension funds.) Pension fund holdings of Treasury securities are large enough to be of concern to the Treasury market if pension funds were discouraged from short-term trading in public securities. Broader limits affecting investors other than pension funds would of course have more severe consequences for the Treasury markets.

Pension funds, since they are tax-exempt, have little incentive to hold tax-exempt municipal bonds. With respect to mortgage-backed securities, according to the HUD Pension Fund Survey, public, private, and combined union and corporate pension funds held a total of $159 billion of these securities at the end of June 1989, which represents between 15 and 20% of the total market.

The Dole-Kassebaum bill exempts short-term gains that result from a hedging transaction, which would appear to soften the effects on public and money market securities to some degree. It is difficult to draw a precise legal line between hedging and other short-term sales, however. Moreover, hedging is not the only legitimate reason to trade public and money market securities in the short run.

In sum, although it is conceivable that limits on short term trading of equity securities could have a desirable policy result, and even this can be debated, limits on short-term trading of public securities would achieve no clear purpose. The planning horizon of business management, for example, would not be affected. Limits on short-term trading, however, would reduce liquidity in the public debt markets, impede the highly efficient credit system which has evolved in the financial markets, and ultimately raise the cost of borrowing for the public entities (including individual homebuyers) that need access to the capital markets. Moreover, investors -- banks, corporations, and individuals -- would find it more costly to hedge their portfolios against risk through short-term investment in public securities and to adjust to economic news about inflation and interest rates. For these reasons, PSA opposes efforts to discourage short-term trading of public and money market securities.

STATEMENT OF THE U.S. CHAMBER OF COMMERCE

The U.S. Chamber of Commerce appreciates this opportunity to present its views on the taxation of short-term capital gains of pension funds.

Senators Kassebaum and Dole have introduced the "Excessive Churning and Speculation Act of 1989" (S. 1654). This legislation would impose a 10 percent excise tax on capital gains from pension fund assets sold within 30 days of purchase and a five percent excise tax on capital gains from assets sold within 180 days of purchase. The tax would be imposed on each particular gain and not on capital gains net of losses over the year.

The Chamber believes that this proposal, however well-intentioned, should be opposed because of the highly detrimental impact that it would have on the private pension system. The present system has worked well to provide retirement benefits for the majority of working Americans. S. 1654 would raise the already high cost of maintaining a private pension plan and force employers to either reduce their benefits or make substantially larger plan contributions. Some employers, particularly small firms already overwhelmed with the expense and complexity of current requirements, will simply discontinue their retirement plans. The reduced benefits and plan terminations that S. 1654 would cause would, in turn, require greater government expenditures as the private pension system declines. Furthermore, the Chamber is also concerned that the proposal, if enacted, is likely to be followed quickly by additional attempts to raise revenues at the expense of the private retirement plan system.

The Chamber is in favor of strengthening rather than impeding private retirement benefit plans as a vehicle for retirement savings. There are two basic means of achieving this goal. First, the earnings of these plans should continue to be exempt from taxation until distributed to plan participants. Pension fund managers have a fiduciary duty to plan participants to achieve the highest rate of return on their portfolio. The Kassebaum-Dole measure would punish pension fund managers for making decisions in the best interest of plan participants. Moreover, the legislation would be the first step toward taxing pension funds on their earnings. Second, the expense and administrative complexity of maintaining a plan must be reduced. The Chamber submitted some of its recommendations on how to simplify the pension plan system to the Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service of the Committee on Finance in connection with the hearing held March 23, 1990, on pension plan simplification.

The Kassebaum-Dole bill rests, in the final analysis, on two related and flawed premises. Presumably, the authors believe that capital gains accruing in less than six months are economically counterproductive and deserve punitive taxation. Alternatively, they believe that the practice of purchasing and rapidly selling securities—what they pejoratively label "churning"—is economically destructive and deserves punitive taxation.

A capital gain accrues to the benefit of an asset owner when the marketplace determines that the present value of the asset's income stream has increased. In the case of a stock, that can occur primarily for two reasons. First, the market may have concluded that a company's future earnings potential has improved. Often, that will be the case because the prospects for the company's industry have improved; a new product has been launched that will increase profits; new management is expected to improve results; or new information has come to the attention of market participants. Obviously, people will disagree about predictions with respect to the future of anything so uncertain as the future of a particular industry or company. That, ultimately, is why there is a buyer and a seller for every transaction. The buyer thinks that prospects are good for the company or industry; the seller does not. Second, the present value of a company's future earnings stream will increase if interest rates generally decline.

New information is constantly being assessed by securities' owners, and different owners will interpret new information differently. Sometimes, new information will come to light within a short period that will change an owner's assessment and induce him to sell. However, in the aggregate, the constant reassessment by many relatively small market participants leads to relatively small and gradual changes in the price of the underlying security.

This constant reassessment and revaluation is the very essence of what makes the free market such a successful mechanism for allocating resources, including capital resources. Attempts to impede information flow and to alter the pricing mechanism—the market price of an asset is the most important single economic fact that can be known about an asset—will cause resource misallocation and reduce the productive capacity of the economy. Any proposal that reduces liquidity of the marketplace and discourages certain transactions, as the Kassebaum-Dole proposal would, will simply reduce market confidence and impede the timely repricing of assets and result in greater price swings over any given period.

Sometimes, this reassessment by the market is dramatic and discontinuous because a large market participant has decided that a company's shares are worth more than the price for which they are presently being traded. Often, the buyer's offer is intended to purchase a controlling interest in the firm. Obviously, the buyer believes that other market participants undervalue the company's prospects and the value of its assets. Only time will decide the issue.

The impact on the economy when assets change owners or price is not negative. When a pension fund sells the shares of a company to a buyer who values the shares more highly, the economy is not harmed. The shares do not disappear. The assets of the firm are not dissipated.

Perhaps most importantly, the fact that the seller of the security has owned the asset for any particular period prior to selling it to the buyer is irrelevant. It does not matter to the economy of the U.S. whether the buyer buys from someone who has owned the asset for one month or one year.

S. 1654 should be opposed because of the highly detrimental impact that it would have on the private pension system. It would raise the cost to a firm of providing a pension for its employees by either reducing the return on the plan's assets or by taxing its return prior to distribution to the plan's participants. It would establish the adverse precedent of taxing pension funds prior to the distribution of their assets to pensioners and result in higher government expenditures to make up for lost pension income. In addition, the proposal rests on the flawed premises that holding on to a security for a short period is *per se* bad for the U.S. economy.

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